policy studies

#11

Foreign Direct Investment in Ukraine

Despite its natural advantages, Ukraine has one of the lowest rates of FDI in the CEE/CIS region. A survey of foreign investors reveals the main reasons for Ukraine's under-performance in terms of FDI to be its inferior investment climate (legal, economic, and infrastructure), as well as deficiencies in the country's privatisation approach and effort. Given that market seeking is a dominant drive of foreign investors, Ukrainian policy should focus on lowering entry barriers.

Another study shows that most foreign investors in Ukraine are in favour of land privatisation, and that they would be willing to increase their investment commitments to Ukraine if land was a tradable commodity.

june 2000

international centre for policy studies

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Defining the Interests and Potential of Foreign Direct Investors in Ukraine

Preface

This study focuses on investigating the possible links between foreign direct investment (FDI) and privatisation policy in Ukraine by surveying foreign investors who are interested in Ukraine as a recipient country. Out of all the identified groups of direct investors (multinational, institutional, and entrepreneurial), multinational enterprises (MNEs) are of the greatest interest as best practice firms whose resources dominate over those of the rest of the investor categories.

The study was performed by the Flemings/SARS Consortium, led by Robert Fleming & Co. Limited, as part of the project "Strengthening the State Property Fund: Individual Privatisation of Enterprises" within the technical assistance component of the Enterprise Development Adjustment Loan from the World Bank. The Flemings/SARS Consortium hired Alina Kudina and Vitali Nosov as short-term consultants to work on the study. This study report is being published with the permission of the State Property Fund of Ukraine.

The study is based on a survey which was conducted in December 1999–January 2000 and covered 34, foreign direct investors who entered or were seeking to enter Ukraine's market.

The report is organised in five chapters. The first chapter reviews Ukraine's track record in attracting FDI. The second starts with a theoretical framework for analysing the motives of foreign direct investors and the role of privatisation in channelling FDI. 'Data and Survey Methodology' describes the survey technique, as well as provides a profile of the sample of investors. 'Survey Findings' summarises and analyses the survey responses. 'Policy Recommendations' infers policy recommendations for Ukrainian authorities.

The authors of this report are grateful to all respondents for their cooperation and valuable input to this study.

Executive Summary

FDI Underperformance

Despite its natural comparative advantages, Ukraine has one of the lowest rates of FDI in the CEE/CIS region. Its current FDI stock per capita equals US$65 (as of 1999), which exceeds only that of Belarus, Uzbekistan, and Tajikistan.

Survey Targets

In order to identify the reasons for FDI underperformance in Ukraine, we performed a mail survey of 65 companies with representation in Ukraine, grouping them into multinational enterprises (MNEs), multilateral financial institutions, private institutional investors, and entrepreneurs. Besides requesting them to identify the major deterrents to investment and to estimate the significance of privatisation for FDI, the survey also asked the sampled investors about their motives, risk appetite and decision-making mechanisms while investing in Ukraine. We also inquired about the investors' assesment of priorities for their investment-enhancing policy agenda. The resulting sample includes 32 entities: 2 multilateral financial institutions, 5 entrepreneurial firms, 3 direct equity funds, and 22 MNEs. The response ratio was 50%.

As was to be expected based on the accumulated evidence from other transition economies, Ukraine's underperformance in terms of FDI is to be explained, at least partly, by its inferior investment climate (legal, economic, and infrastructure aspects), as well as by deficiencies in the country's privatisation approach and effort. Implicit evidence for the inadequacy of Ukraine's privatisation effort may be found in the fact that most of the mail survey respondents (including 60% of the MNEs) reported that they had invested in Ukraine through green-field projects or joint ventures with private companies rather than through privatisation offerings—whilst many of the multinational companies not currently looking at investing in Ukraine also proclaimed their preference for green-field investments.

Origin of Investments

As of January 2000, the mail survey respondents committed over US$2 billion in FDI, which represents almost two-thirds of Ukraine's total FDI stock, and employed some 9,000 people. By country of origin, the USA was by far the largest investor, with the European Union second. Our sample omitted

Russian firms, a significant group of investors in Ukraine, as we tried to focus on best practice, which is typically found among Western firms. In addition, Russian firms are typically more secretive about their business dealings than their Western counterparts.

Sectoral Preferences

In terms of sectoral preferences, the sampled firms were most frequently found in the food/beverages sector (the #1 destination for FDI in Ukraine, according to official statistics), followed by agriculture and telecommunications. Other prominent investment targets included the mechanical engineering, retail/fast food, banking, and consumer goods sectors.

Investment Amounts

In terms of investment amounts, the sample in Ukraine seems to range across a wide spectrum, with the greater proportion being on medium-sized investments (US$10–100 million). Besides the EBRD, only MNEs were able to commit amounts over US$100 million. In the makeup of investments, institutional investors (multilateral and private) invest mostly cash, while entrepreneurs and MNEs make most of their contributions in kind.

Investment Motives

The survey provides strong evidence that market-seeking activities are the most dominant motives for FDI in Ukraine, well ahead of other possible reasons (including pursuit of cheap and qualified labour). Most investors are attracted to Ukraine by its extensive domestic market of 50 million people. The availability of low-cost labour turned out to be insignificant for the majority of companies surveyed, except entrepreneurial investors who tend to be more sensitive to the availability of cheap input factors. Although Ukrainian wages are lower than in other East European countries, this competitive advantage is diminished by significantly lower labour productivity, the lack of capital, inferior management, and regulatory burdens, making unit costs higher in Ukraine than in neighbouring countries.

Expected Internal Rates of Return (IRRs)

Although Ukraine is one of the most risky countries in the CEE region, the required IRR is only 10–30% for the majority of investors. Large multinationals that enjoy a low cost of capital usually require lower returns (below 20%) than institutional and entrepreneurial investors. Due to their relatively low cost of capital and given their political goals, multilateral institutions can undertake investment projects in Ukraine with a single-digit IRR. However, their resources are unlikely to cover Ukraine's investment needs, and they often cannot make investments without Western industry operators involved. MNEs are therefore the best option for long-term investment in Ukraine.

Timeframe for Decision Making

Most survey respondents reported that their investment decision making takes typically more than 6 months. Institutional investors can usually decide on certain investment projects within a period of 3 to 6 months. However, they tend to have the highest number of decision makers (5). On the other hand, some entrepreneurial investors can commit to investing within a month after the opportunity is identified. On average, in such organisations 4 persons are involved in taking the decision on investment in Ukraine. The most complicated and lengthy decision-making process was reported for multilateral financial institutions.

Major Deterrents for FDI

The survey ranks the major deterrents to FDI in Ukraine in the following order (descending in significance):

- instability and exorbitance of the regulations;
- ambiguity of the legal system;
- uncertainty of the economic environment;
- corruption;
- high tax burden;
- problems establishing clear ownership conditions;
- depressed disposable income levels;
- difficulty negotiating with government and privatisation authorities;
- volatility of the political environment;
- lack of physical infrastructure;
- problems in accessing domestic and export markets.

It is noteworthy that all these impediments were recognised as causing problems. Though on the lower end of the ranking, clarity of ownership rights and ease of negotiating with government/privatisation authorities were ranked between ‘major problem’ and ‘minor problem’, i.e., they were perceived as significant FDI deterrents.

Suggested Policies

The policy agenda priorities suggested by the survey respondents comprised the liberalisation of capital, foreign exchange and profit repatriation controls, the lifting of restrictions on foreign ownership and control, the minimisation of red tape, and the reduction of tax rates and number of taxes. On the other hand, improvements in physical infrastructure and increasing import barriers were rated to be of low priority. In brief, the suggested policy agenda may be summarised as follows: investors want to deal with fewer government officials, and less frequently. Many of them believe that a comprehensive and rigorous privatisation approach would lead to this end.

Importance of Privatisation Policies

As anticipated, the status of privatisation in Ukraine was found to be significant for the majority of mail survey respondents. Only 5% of respondents (deep-pocketed MNEs) found privatisation status unimportant in their activity. For the rest of the investors (95%), privatisation policy appears to be a very significant factor, which affects their investment decisions. It is expected that privatisation will not only create new acquisition opportunities, but also enhance the overall business climate, through productivity growth and reduction of unproductive government interference. While the importance of privatisation in creating acquisition opportunities was recognised by most institutional (private and multilateral) and entrepreneurial investors, it was surprising to note that the sampled MNEs do not significantly rely on privatisation while structuring their strategy in Ukraine.

Policy Recommendation

The survey results in a number of policy recommendations for Ukraine’s FDI policy in general, and its privatisation policy in particular. In a nutshell, Ukraine’s privatisation policy has to be tailored more towards the preferences of MNEs, who have so far failed to participate in Ukraine’s privatisation process in any significant way.

Ukraine's Track Record in Attracting FDI

Ukraine has the dubious distinction of being one of the least attractive countries for foreign investors in Eastern Europe and the former Soviet Union. Ukraine has lagged behind other Eastern and Central European countries in attracting FDI flows to its territory.

Foreign direct investment (FDI) is defined as an investment involving a long-term relationship and reflecting a lasting interest and control of a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor[1].

Whilst financial aid from multilateral institutions (e.g., IMF, World Bank, EBRD) is of crucial importance for Ukraine in the short term, in the longer term developing countries need to rely on private capital flows to provide non-debt sources of funding for monetary stabilisation and restructuring. This claim is supported by the experience of developing countries like Malaysia, Singapore, Taiwan, and Thailand, which have been highly successful in building a development strategy based on foreign investment.

Ukraine is a potentially attractive place to invest, insofar as the country possesses a large amount of unused or underused physical and human capital, substantial reserves of idle savings (estimated in the billions of US dollars), a large domestic market of 50 million people (one of the largest in Europe), and easy access to the even larger markets of Russia and other former Soviet republics. In addition, due to its strategic importance, Ukraine is now the third-largest recipient of US foreign aid, after Israel and Egypt. Ukraine has also received substantial funding from multilateral organisations such as the World Bank, the IMF, and the EBRD. Much of this funding has been given in the form of technical assistance for building a market economy and a framework of legal institutions to underpin the capitalist economy.

Nevertheless, Ukraine has the dubious distinction of being one of the least attractive countries for foreign investors in Eastern Europe and the former Soviet Union. Ukraine has lagged behind other Eastern and Central European countries in attracting FDI flows to its territory. Moreover, in 1999 FDI net inflows declined vs. the moderate 1996–98 levels, presumably because of the depressed state of the domestic economy and the perception of a heightened political risk in the country due to the parliamentary and presidential elections.

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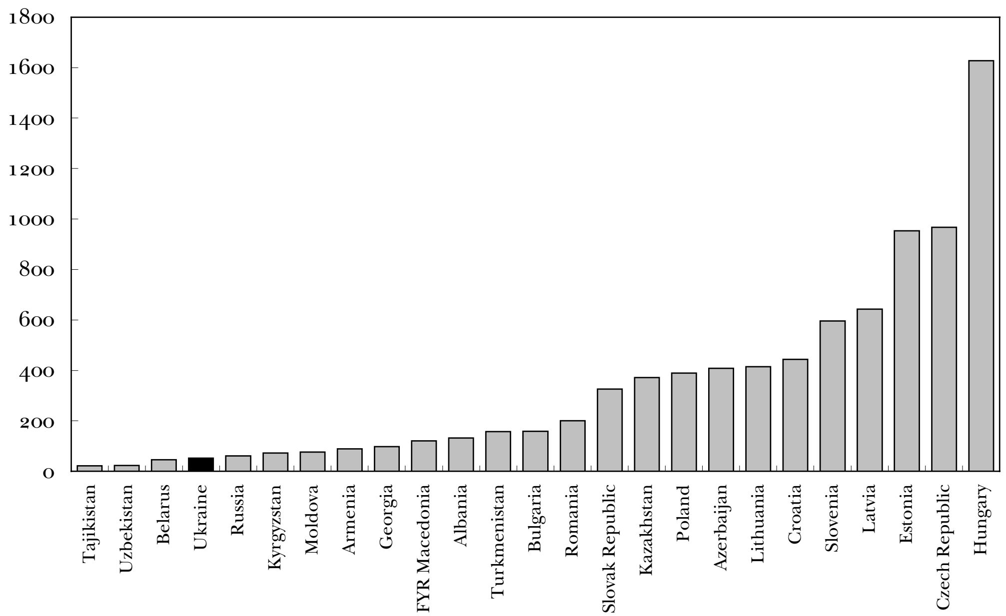
[1] *World Investment Report 1998: Trends and Determinants,* UNCTAD (New York and Geneva 1998)

According to official Ukrainian data, as of early January 2000, the cumulative FDI inflow into Ukraine since 1991 approached US$3.3 billion. In 1999, Ukraine received only US$491 million.

In 1997–98, Ukraine's performance in winning FDI was roughly at par with the CIS average and Russia. However, within its peer group of other transition economies in Central and Eastern Europe and the NIS, Ukraine has outperformed only Belarus, Tajikistan, and Uzbekistan.

Cumulative FDI (1989–98) per capita

US$



Source: EBRD Transition Report 1999

From a sector perspective, as of early January 2000, the main destination of FDI in Ukraine was the domestic food industry (20% of cumulative FDI), followed by domestic trade operations (over 17%) and mechanical engineering/metals (almost 11%). This sectoral ranking has persisted in its current configuration since late 1998.

By origin of investment, the United States has been the dominant foreign investor. US companies have made investments valued at some US$590 million, representing 18% of all FDI made in Ukraine. The USA is followed by the Netherlands with 9%, the Russian Federation (9%), Germany (7%) and the United Kingdom (7%). The prominent position of Cyprus (6%) is explained by the fact of its favourable tax arrangements with Ukraine, which has caused many Ukrainian—also Western—companies to use Cyprus as a location for newly founded companies investing in Ukraine.

FDI Stock by Country of Origin

cumulative, since 1991

Country	January 1, 1999		January 1, 2000	
	US$ mil	% of total	US$ mil	% of total
United States	511	18.9	590	18.1
Netherlands	270	10.0	301	9.3
Russia	187	6.9	288	8.9
United Kingdom	201	7.4	243	7.5
Germany	230	8.5	230	7.1
Cyprus	150	5.6	196	6.0
South Korea	186	6.9	171	5.3

Source: State Statistics Committee

Theoretical Framework

Host Country Determinants of FDI

Economic determinants of FDI can be grouped into three clusters: resource-seeking, market-seeking and efficiency-seeking

The most important determinants for the location of FDI are economic considerations, which we will examin in turn. They come into full play once an enabling FDI policy framework is in place. Being based on the principal motivations of MNEs for investing in foreign countries, economic determinants can be grouped into three clusters: resource-seeking, market-seeking and efficiency-seeking, as shown in the table below.

The availability of natural resources, cheap unskilled or semi-skilled labour, creative assets, and physical infrastructure promote resource-seeking activities. Historically, the most important host country determinant of FDI has been the availability of natural resources, e.g., minerals, raw materials and agricultural products. In the nineteenth century, "much of the FDI by European and United States firms was prompted by the need to secure an economic and reliable source of minerals, primary products for the investing industrialising nations of Europe and North America"[2]. Up to the eve of the Second World War, about 60% of the world stock of FDI was in natural resources.

Host Country Determinants of FDI

Host country determinants	Type of FDI classified by motives of firms	Principal economic determinants in host countries
Policy framework for FDI Economic, political, and social stability Rules regarding entry and operations Standards of treatment of foreign affiliates Policies on functioning and structure of markets (especially competition and policies governing mergers and acquisitions) International agreements on FDI Privatisation policy Trade policy (tariffs and non-tariff barriers) and coherence of FDI and trade policies Tax policy	Market-seeking	Market size and per capita income Market growth Access to regional and global markets Country-specific consumer preferences Structure of markets
Economic determinants	Resource/ asset-seeking	Raw materials Low-cost unskilled labour Skilled labour Technological, innovative, and other created assets (for example, brand names), including as embodied in individuals, firms, and clusters Physical infrastructure (ports, roads, power, telecommunications)
Business facilitation Investment promotion (including image-building and investment-generating activities and investment-facilitation services) Investment incentives Hassle costs (related to corruption and administrative efficiency) Social amenities (for example, bilingual schools, quality of life) After-investment services	Efficiency-seeking	Cost of resources and assets listed above, adjusted for labour productivity Other input costs, such as transport and communication costs to/from and within host economy and other intermediate products Membership of a regional integration agreement conducive to the establishment of regional corporate networks

Source: UNCTAD, World Investment Report 1998: Trends and Determinants. Table IV.1. p.91

[2] Dunning, John H. *Multinational Enterprises and the Global Economy,* Addison-Wesley (Wokingham, England 1993)

While being a prominent FDI determinant, the presence of natural resources by itself was not sufficient for FDI to take place. Comparative advantage in natural resources usually gave rise to trade rather than to FDI. Investment took place when resource-abundant countries either lacked the large amounts of capital typically required for resource extraction or lacked the technical skills needed to extract or sell raw materials to the rest of the world. In addition, infrastructure facilities for getting the raw materials out of the host country and to its final destination had to be in place, or needed to be created.

Labour-seeking investment is usually undertaken by manufacturing and service MNEs from countries with high real labour costs. These MNEs set up or acquire subsidiaries in countries with lower real labour costs, to supply labour intensive intermediate or final products. Frequently, to attract such production, host countries have set up free trade or export processing zones.

Another highly important group of economic determinants of FDI are market factors, such as market size (both in absolute terms and in relation to the size and income of its population) and market growth. For multinational firms, new markets provide a chance to stay competitive and grow within the industry, as well as to achieve scale and scope economies. Traditionally, market size and growth as FDI determinants related to national markets for manufacturing products sheltered from international competition by high tariffs or quotas that triggered "tariff-jumping" FDI. Market access was paramount in the wave of the United States investment in Europe during the early post-war period, and in Japanese investments in the United States after the mid-1980s, following voluntary export restrictions and the possibility of further protectionist measures in the automobile industry.

National markets were also important for many service MNEs, although the principal reason was not the existence of tariffs, but the fact that most services were not tradable and therefore the only way to deliver them to foreign markets was through establishments abroad. Apart from market size and trade restrictions, MNEs might be prompted to engage in market-seeking investment if and when their main suppliers or customers have set up foreign production facilities, and if, in order to retain their business, they need to follow them overseas. *However, undoubtedly the most important reason for market-seeking investment remains the action of host governments encouraging such investment.* The traditional instrument chosen by governments has been to impose tariffs or other import controls. History suggests that the majority of first-time manufacturing and service investments were undertaken to circumvent such trade barriers.

The motivation of efficiency-seeking FDI is to rationalise the structure of established resource-based or market-seeking investment in such a way that the investing company can gain from the common governance of geographically dispersed activities. The intention of the efficiency-seeking MNE is to take advantage of different factor endowments, cultures, institutional arrangements, economic systems and policies, and market structures, by concentrating production in a limited number of locations to supply multiple markets. To make the efficiency-seeking foreign production take place, cross-border markets must be both well-developed and open. This is why foreign production usually flourishes in regionally integrated markets. However, it is worth noting that in the early 1990s many of the larger MNEs pursued pluralistic objectives, and most were engaged in FDI that combines the characteristics of each of the abovementioned categories. The motives for foreign production may also change when, for example, a firm becomes an established and experienced foreign investor.

Considering Ukraine as a host country, one could expect a large amount of resource- and market-seeking FDI: the former is due to availability of cheap labour and rather abundant agricultural products; high trade barriers and large internal market promote the latter. In contrast, conditions for efficiency-seeking investment are unclear: from one side, cross-border trade is restricted, from another, Ukraine is a member of different regional integration agreements conducive to trade facilitation.

Types of Foreign Direct Investors

Foreign direct investors may be divided into three categories:

- multinational enterprises, abbreviated as MNEs;
- institutional investors (including multilateral donor organisations like the EBRD and IFC);
- entrepreneurial investors.

Although the notion of a "strategic investor" is most often applied to MNEs (due to the reasons spelt out below), all three investor types can and often do play the role of what is called a ”strategic investor”.

MNEs

MNEs are incorporated or unincorporated enterprises comprising parent enterprises and their foreign affiliates. A parent enterprise in this context is defined as an enterprise which controls legal entities outside its home country, usually by owning a certain equity capital stake. An equity capital stake of 10 per cent or more of the ordinary shares or voting power of an incorporated enterprise, or its equivalent for an unincorporated enterprise, is normally considered as a threshold for the control of assets. A foreign affiliate is an incorporated or unincorporated enterprise in which an investor, who is resident in another country, owns a stake that permits a lasting interest in the management of that enterprise. A foreign affiliate can take the form of subsidiary, associate enterprise, or branch.

As a rule, MNEs are long-term investors who seek market, efficiency, or resource gratification by investing in a certain country. They can sacrifice short-term profits for long-term benefits like market share, R&D potential, or secure resource supply. MNE investment decisions are often motivated by internalisation incentives, such as:

- avoiding search and negotiating costs;
- avoiding costs of broken contracts and ensuing litigation;
- buyer uncertainty;
- capturing economies of interdependent activities and common governance;
- controlling market outlets.

By virtue of being typically well-capitalised companies, MNEs enjoy a relatively low cost of capital, which keeps their required internal rates of return very modest. Their relatively easy access to capital gives them deep enough pockets to tolerate losses for a relatively long period of time. MNEs are typically best practice firms within their industries, and as such are valuable sources of superior technologies and skills, which may lead to enhancements in local production.

Institutional Investors

Institutional investors are financial intermediaries who typically raise funds by selling shares in investment funds to the public and invest the proceeds in a diversified portfolio of securities or equity. By investing in a fund, an investor can obtain broad-based ownership of a sufficient number of securities, either within a sector of the financial market or across market sectors, thus reducing his overall portfolio risk.

Most institutional investors are purely passive portfolio investors, who buy and sell shares on the secondary markets. For reasons of risk reduction, they will typically not take significant positions in one particular company, and are usually not actively involved in a company's management. These passive investors are typically not classified as foreign *direct* investors.

In the context of FDI, only *direct equity (or private equity) funds* enter the picture. These are investment vehicles mostly funded by a pool of investors with medium-term investment horizons (typically 5-7 years). Direct equity funds typically take substantial stakes in target companies (exceeding a blocking minority of 25%), and take an active role in the company's management. They typically aim to exit the investee company within a period of 3-5 years, either through an IPO of the investee firm, a sale to a strategic investor or a sale to the existing owners of the target firm. They achieve their superior returns by taking advantage of capital market inefficiency and by enabling their target firms to invest in value-positive projects. In Ukraine, country-dedicated or region-dedicated funds are most common.

Within the category of institutional investors, there is a separate group of multilateral investors such as the EBRD and the IFC. Unlike their privately financed counterparts, they are funded by governments and as such have distinct investment strategies and investment criteria. Their cost of capital is equal to prime MNEs, while their investment objectives are broader than pure maximisation of returns. In the context of CEE transition economies, their objectives frequently involve facilitation of enterprise restructuring, fostering market conditions, and sustainable development. Therefore, this investor group is treated separately from the rest of institutional investors in our study.

Entrepreneurial Investors

Entrepreneurial investors (entrepreneurial high net-worth individuals or smaller foreign firms operating within few countries) typically act as economic agents who attempt to exploit country/sector/enterprise-specific advantages via direct investment in local companies. Usually, their investment behaviour is opportunistic as they seek high-return possibilities within a short time-horizon. Having a high cost of capital and limited access, they are not in a position to incur continuous losses in anticipation of long-term benefits. They also tend to target smaller enterprises, as limited availability of investment funding makes it difficult for them to digest large businesses, at least at the initial stage.

FDI and Privatisation Policy

The history of privatisation in CEE gave rise to a variety of privatisation methods, ranging from voucher privatisation to management/employee buy-outs and to strategic sales. It is worth noting that these different privatisation methods tend to have vastly different effects on corporate performance. Whilst there is growing evidence suggesting that voucher privatisation, which results in dispersed ownership, often fails to increase the efficiency of privatised enterprises, market entry by foreign firms tends to create competition and has a positive effect on the transition process. The World Bank classifies the trade-offs among privatisation methods as follows:

Trade-offs among Privatisation Routes (large firms)

Method/Objective	Better corporate governance	Speed and feasibility	Better access to capital and skills	More government revenue	Greater fairness
Sale to outside owners	+	-	+	+	-
Management-employee buyout	-	+	-	-	-
Equal-access voucher privatisation	?	+	?	-	+
Spontaneous privatisation	?	?	-	-	-

Source: 1996 World Development Report, World Bank

Privatisation and Corporate Performance in Ukraine

A recent study conducted by Estrin and Rosevear[3], which was based on a survey of 150 Ukrainian firms, seems to challenge the general hypothesis regarding the positive relationship between privatisation and improved corporate performance. Based on a measurement of productivity and profitability

[3] Estrin S.; Rosevear A. *Enterprise Performance and Corporate Governance in Ukraine,* Paper presented at London Business School CIS-Middle Europe centre Workshop on Corporate Governance in Russia (1998)

between privatised and state-owned firms, the study claims that, contrary to common expectations, privatised Ukrainian companies have not been able to deliver performance superior to state-owned companies.

However, Estrin and Rosevear's study admits that within their sample (and among Ukrainian enterprises overall) the weight of foreign direct ownership was negligible. The privatised companies investigated typically had mostly individuals, financial intermediaries, and banks as "outside owners". This is due to the fact that in the period between 1991 and 1999, management-employee buyouts and voucher privatisation were the preferred privatisation methods. These forms of privatisation failed to bring more investment, more efficient management, or better performance to the majority of Ukrainian enterprises.

Although mass privatisation allowed for access to Ukrainian enterprises by outsiders, qualified outside investors remained largely on the sidelines. Thus, the failure to attract best-practice firms as strategic investors for local enterprises is the major contributing factor in explaining the limited privatisation impact in Ukraine.

The absence of significant foreign strategic ownership might explain their failure to identify any positive impact of privatisation on corporate performance. Other reasons for the absence of clear evidence of a positive impact of privatisation on the performance of Ukrainian enterprises may be the following:

- A weak legal framework makes it hard for outsiders to exercise any real control over companies in which they have a majority stake.
- Outsiders gain dominant shareholdings only in the worst firms, since insiders control the privatisation process.
- Most enterprises have been privatised for less than three years; the benefits of privatisation may therefore still lie in the future.
- One-third of privatised enterprises still have the government as a substantial shareholder (up to 30%).
- Government continues to interfere in some sensitive sectors (e.g., energy sector).
- Insiders are dominant owners in the ownership structure of many medium-sided and a majority of large enterprises.

At the same time, other studies on corporate performance in Ukraine show a slightly different picture. For example, a recent study by Szyrmer et al.[1] indicates that by 1997 differences started to emerge in the performance of mainly government-controlled and non-government controlled sectors. Industrial sectors, which are not subject to government regulation of prices, conform to the generally accepted pattern whereby non-state enterprises typically display a more efficient use of labour and capital, and thus achieve better profitability.

In sum, although mass privatisation allowed for access to Ukrainian enterprises by outsiders, qualified outside investors (i.e., best-practice firms acting as strategic investors) remained largely on the sidelines. Thus, the failure to attract best-practice firms as strategic investors for the local enterprises is the major contributing factor in explaining the limited impact of privatisation in Ukraine.

Data and Survey Methodology

Description of Survey Approach

We performed a detailed survey of foreign investors, who were asked to answer a questionnaire on their perception of the risks and rewards for direct investment. While selecting the companies, we tried to form a representative sample. As of the date of the survey respondents had invested, or committed to invest, over US$2 billion in Ukraine.

We performed a detailed survey of foreign investors, who were asked to answer a questionnaire on their perception of investment risks and rewards for direct investment in Ukraine, as well as their view on the role of privatisation. The survey was conducted through personal interviews and mail-out questionnaires, addressed to senior executives of foreign companies already operating in Ukraine or intending to launch Ukrainian operations.

While selecting the companies, we tried to form a representative sample by taking into account different types of industry, company sizes, countries of origin, and types of investment. The sectors of most interest to investors (food processing, trade and commerce, engineering and metals, finance and insurance, chemicals) found their representation in the sample. The sample also includes companies of different sizes. In addition, representatives of all the four identified types of investors (MNEs, entrepreneurs, investment funds, and multilateral institutions) were included in the sample.

The target sample was made up of 60 companies. Out of the 60 companies contacted, 34 responded, constituting a normal response ratio for a survey of this kind. The final sample may be divided as follows:

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[1] Szyrmer, J.; Dubrovskyj, V.; Shigaeva, T. “Non-government sector works better”, *Policy Studies,* 1999,#1, p.49.

Foreign Investors: Survey Participants

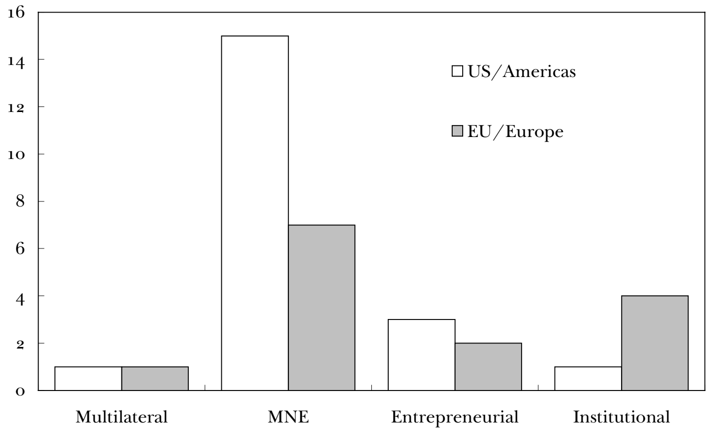
Type of Investor	Contacted		Replied	
	Number	% of total	Number	% of total
MNE	41	68	22	65
Entrepreneurs	9	15	5	15
Institutional	8	13	5	15
Multilateral	2	3	2	6
Total	60	100	34	100

Source: Flemings/SARS survey

Portrait of Mail-Shot Survey Sample

As of the date of the survey, i.e., January 2000, the survey respondents had invested, or committed to invest, over US$2 billion in Ukraine. This represents almost two-thirds of the total FDI stock in Ukraine.

Geographic Distribution of Sampled Companies



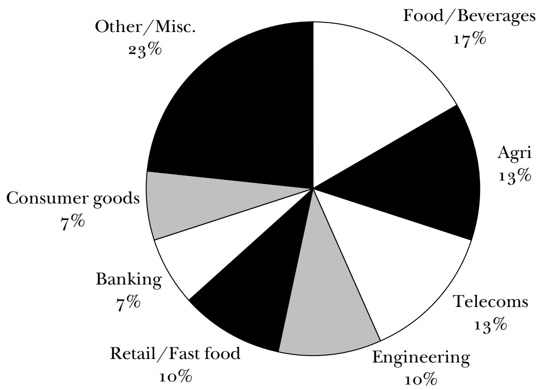
Source: Flemings/SARS survey

In terms of the country of origin, US firms prevail. This is consistent with the aggregate FDI statistics, which indicate the USA as the #1 country of origin for FDI in Ukraine. Out of the 34 companies surveyed, 19 companies are headquartered in the US, one in Canada, and the rest are in the EU or elsewhere in Europe. American firms dominate among MNEs and entrepreneurial firms, while Europeans prevail among institutional investors.

Our resulting sample is not fully balanced between the major types of investors (MNEs, entrepreneurs, investment funds and multilateral institutions). However, this imbalance reflects the fact that MNEs make up the dominant investor group in Ukraine in terms of investment amounts. They also represent our focus group, owing to their superiority (as best-practice firms) as strategic investors. Therefore, MNEs account for two-thirds of the survey respondents.

The next chart depicts our sample breakdown, according to the sector of investment.

Distribution of Sampled Companies by Sector



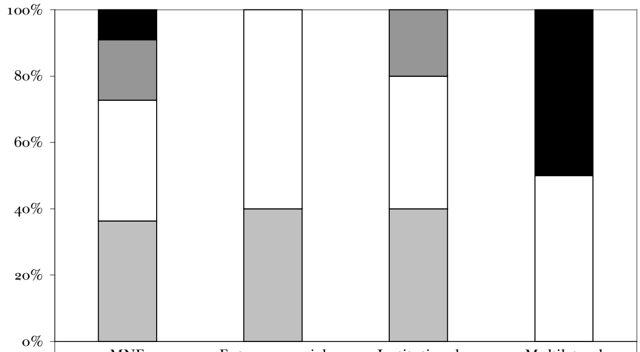
Source: Flemings/SARS survey

Overall, the sector structure of the sampled firms turned out to be in line with countrywide patterns. In agreement with Ukraine's statistics, the food sector assumes the top position as an FDI destination in our sample. Besides MNEs, it is also the prime sector of focus for institutional investors, owing to its superior fundamentals and competitive position in the Ukrainian economy. Ukraine's food sector is followed by agricultural business, telecoms and engineering[4].

[4] Whilst this proportional distribution of the industry sectors of interest to the sampled firms corresponds with the overall FDI statistics, and this suggests that the sample presents an adequate representation of industry preferences worldwide, the sample may not be fully representative. Secondly, there might be a self-selection bias, i.e., in focusing mostly on the firms with representation in Ukraine, we might have omitted other potential investors who would like to

In terms of investment amounts, the sample seems to be representative across a wide spectrum of investments. However, greater emphasis is accorded to medium-size investments (US$10-100 millions), which account for the majority of FDI inflows to Ukraine.

Distribution of Sampled Companies by Investment Size



	MNE	Entrepreneurial	Institutional	Multilateral
■ >US$100 mil	2			1
▨ US$50-100 mil	4		1	
□ US$10-50 mil	8	3	2	1
▨ <US$10 mil	8	2	2	

Source: Flemings/SARS survey

Multilateral institutions turned out to be the source of one of the largest FDI inflows to Ukraine. Other institutional investors, especially private investment funds, also emerged as a source of significant direct investment transactions. All the funds sampled have sizes of double-, sometimes triple-digit million US dollars. In the group of MNEs, those with investments of less than US$10 million fall in the category of "potential investors", as they have yet to commit significant funds into full-blown Ukrainian operations (beyond opening a representative office and build-out of distribution networks). Nevertheless, more than half of the sampled MNEs have already committed/invested amounts within the US$10–100 million range.

Looking at FDI in terms of contribution types, our expectation that institutional investors (institutional and multilateral) prefer cash investments to investments in kind turned

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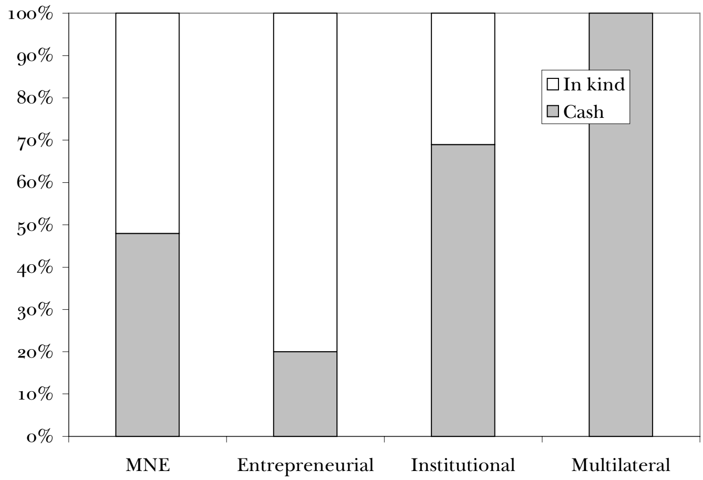
invest in Ukraine, provided there was a better investment climate or/and privatisation effort (e.g., energy sector, hotels, retailing).

out to be true: 70% or more of their investments were made in cash form. This is a natural implication of their role as financial intermediaries. By contrast, MNEs and entrepreneurial firms rely more on investments in kind: over 50% of the MNEs and 80% of entrepreneurial firms. Being specialists within their sectors, these kinds of investors try to replicate locally their operational standards developed elsewhere, by importing their standard equipment and technology.

Investment Makeup by Investor Group



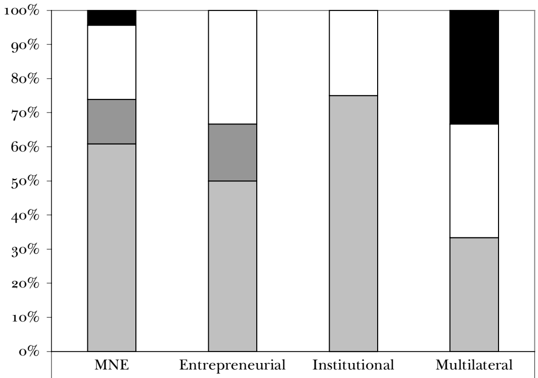
Source: Flemings/SARS survey

The chart below displays the breakdown of sampled companies by "mode of entry". Four types of entry structure were identified:

1. Green-field project/start-up;
2. Acquisition of existing local businesses:
   - through privatisation of a state-owned enterprise;
   - through acquisition of a privatised enterprise;
   - through acquisition of a private start-up.

We found that most foreign investors sampled entered Ukraine via green-field projects: 50% of entrepreneurial investors, 60% of MNEs, and over 70% of institutional investors. Acquisitions via privatisation offerings were found to be rare among MNEs and entrepreneurs, and non-existent for institutional and multilateral investors. Private start-up companies also figure very rarely in acquisitions, as few of them have yet grown into attractive acquisition targets. However, privatised (formerly state-owned) enterprises were more frequently found to be acquisition targets (presumably due to their lack of capital for expansion).

Distribution of Sampled Companies by Mode of Entry



	MNE	Entrepreneurial	Institutional	Multilateral
■ Acquisition of start-up	1			2
□ Acquisition of privatised firm	5	2	1	2
▩ Acquisition via privatisation	3	1		
▨ Green-field	14	3	3	2

Source: Flemings/SARS survey

Survey Findings

Motivation Profile of Foreign Investors in Ukraine

Market-seeking is the dominant objective for foreign investment in Ukraine, with efficiency- and resource-seeking motivations of not more than secondary significance.

We started our analysis of foreign investors' attitudes in Ukraine by distinguishing among the three main types of strategic motivation for investment projects in Ukraine, namely (1) market-seeking, (2) resource-seeking, and (3) efficiency-seeking. The answers given by the firms participating in the survey indicate that market-seeking is the dominant objective for foreign investment in Ukraine; in fact, it was the major motive for 93% of all respondents, with efficiency- and resource-seeking motivations of not more than secondary significance.

The firms' motives were ranked in order of their importance for the investment decision. Average response (AR), which demonstrates a degree of importance of a particular reason, was calculated for each of the motives under consideration as the arithmetic mean of respondents' replies. The interviewees chose among 3 grades ranging from "major reason"=1; "minor reason"=2; "not have a reason"=3. Therefore, the closer the degree of importance is to 1, the more important is the corresponding motive.

Motives for Companies Investing in Ukraine

Rank	Why did you choose to invest in Ukraine?	Average Response				
		MNE	Entre-pren.	Institut.	Multilat.	Total
1	Market size and potential for market growth	1.2	1.3	1.0	1.0	1.05
2	Access to a new regional (Central/Eastern Europe, CIS) market	1.9	2.7	1.7	2.0	1.92
3	The skill quality of production labour	2.1	2.3	2.0	2.5	2.15
4	Availability of low-cost input factors (e.g., cheap labour; energy; raw materials)	2.2	1.7	2.5	3.0	2.27
5	Production capacities	2.2	3.0	2.0	2.5	2.32
6	To improve competitiveness in supplying established markets (e.g., Western Europe)	1.9	2.7	2.5	3.0	2.53
7	Tax incentives	2.3	3.0	3.0	3.0	2.69
8	A chance to access research and technological expertise available in Ukraine	2.7	3.0	3.0	3.0	2.71

Source: Flemings/SARS survey

Ranking of Motives

Market seeking emerges as the most common strategic motivation for investment in Ukraine. Only in one case was the extension of sales to the Ukrainian market seen as a secondary objective. The desire to supply the Ukrainian market dominates over other reasons (AR=1.05, making it a major motive for 93% of respondents) while the next important reason, i.e., access to a new regional (CEE/CIS) market, has an AR of only 1.92. Average resource- and efficiency-seeking activities have AR values of only 2.27 and 2.53, respectively, which shows that they are only secondary motives, and were frequently regarded as being irrelevant to the decision.

Evaluation of Investment Motives in Ukraine

Rank	Motive	Average Response
1	Market seeking	1.05
2	Resource seeking	2.27
3	Efficiency seeking	2.53

Source: Flemings/SARS survey

Resource-seeking motives are the next most important and include the skill quality of labour (AR=2.13) and the availability of low-cost inputs (AR=2.27). However, the AR figures show that the skill quality of production labour is treated as a minor reason by most investors (even skewed towards "no reason"): only for 17% of respondents was skill quality of primary importance, while for 42% it was of no importance. Similarly, the easy availability of low-cost labour was considered as an important reason by only 14% of respondents. It is remarkable that 66% of interviewees considered cheap inputs to have had no importance at all in their investment decisions.

With respect to the relative significance of existing *production capacities* to foreign investors' decision-making process, the high AR of 2.32 shows that foreign investors are hardly attracted by available production capacities in Ukraine. It seems that the attractions of even some of the more modern production facilities operating in Ukraine are cancelled out by the deficiencies of Ukraine's privatisation process, which so far has made it difficult for investors to participate on an equal footing.

The remaining three motives (to improve competitiveness in supplying established markets, tax incentives, and a chance to access particular research and technological expertise available in Ukraine) are ranked as comparatively unimportant. A surprising feature is the unimportance of tax incentives to investment decisions. Although a country's tax policy is usually considered an important decision-factor for foreign investors, in Ukraine it seems to be less relevant. This may be explained by the high variability of Ukraine's tax system and the unreliability of its legal system.

The Prevalence of Market-Seeking Activities in Ukraine: Results of the German Advisory Group Study

The evidence of market-seeking prevalence in Ukraine is also supported by recent research performed by the German Advisory Group (GAG) in 1998. A sample of 20 foreign investors was chosen and their motives for committing capital to Ukraine were examined. The respondents assessed the importance of each particular motive among 4 grades ranging from "very important"(=4), "great"(=3) and "slight"(=1) to "unimportant"(=0)[5].

The results of the GAG report confirm the findings of our survey, insofar as they also rank the three sales-oriented motives as issues of primary concern to FDI providers in Ukraine, with the additional motives being of secondary importance.

Another part of the GAG paper analyses how the importance of different motives for investment decisions varies across potential recipient countries. The significance of different factors responsible for investment decisions is estimated by introducing an "overall indicator of significance" (IS), calculated as the mean of the average scores of all respondents to each of the twelve motives investigated in the study. Thus, the IS for Ukraine equals:

$$IS_{Ukraine} = (3.65 + 3.50 + 2.50 + 1.70 + 1.58 + 1.40 + 1.10 + 1.20 + 0.68 + 0.55 + 0.54 + 0.33)/12 = 1.56$$

Similarly, $IS_{CEE} = 1.88$; $IS_{Russia} = 1.84$ and $IS_{Czech\ Republic} = 1.70$

These indicators constitute the criterion to determine which factors act as major stimulants for attracting foreign investment in a particular country. A higher score than the IS for a factor means that it is a significant determinant of investment in that country (high influence) and a lower score indicates a factor that does not play an important role in the decision process (low influence).

[5] Moellers, Felicitas. "Foreign Direct Investment in Ukraine - Experiences Taken from Reality" in *Ukraine at the Crossroads: Economic Reforms in International Perspective*, Physica (Berlin, New York 1998)

Motives for Companies Investing in Ukraine and Some Other Transition Countries

Rank	Motive	Ukraine	CEE	Russia	Czech Rep.
1	Secure potential sales markets	3.65	3.08	2.96	2.63
2	Develop new sales markets	3.50	3.22	2.95	2.75
3	Overcome import barriers	2.50	1.36	1.72	0.85
4	Secure and cultivate existing sales markets	1.70	2.70	3.00	2.57
5	Enhance competitiveness through primary production in the host country	1.58	2.12	1.94	2.72
6	Lower labour costs	1.40	2.76	2.16	3.34
7	Lower tax burden	1.20	1.46	1.58	1.48
8	Better purchasing and procurement possibilities	1.10	1.34	1.58	1.11
9	Longer working hours	0.68	1.38	0.95	1.73
10	Fewer administrative impediments	0.55	1.18	1.83	0.96
11	Longer machine running times	0.54.	1.21	0.79	2.00
12	Less stringent environmental constraints	0.33	0.73	0.58	0.81

Source: Mollers, (1998) "Foreign Direct Investment in Ukraine – Experiences Taken from Reality"

The GAG paper demonstrates the differences in the significance of twelve decision-factors among countries using the following matrix. On the vertical axis the matrix lists the twelve prospective influences, according to the scores obtained in the survey. On the horizontal dimension it lists the four countries under consideration. The vertical axis is divided into high-influence and low-influence on the decision-making process, with the break point between these two at country-specific IS.

Matrix Positioning of FDI Determinants in Transitional Countries

	Ukraine	CEE	Russia	Czech Republic
4.00 3.00 **high** 2.00	Secure potential sales markets Develop new sales markets Overcome import barriers Secure and cultivate existing sales markets Enhance competitiveness through primary production in the host country	Develop new sales markets Secure potential sales markets Lower labour costs Secure and cultivate existing sales markets Enhance competitiveness through primary production in the host country	Secure and cultivate existing sales markets Secure potential sales markets Develop new sales markets Lower labour costs Enhance competitiveness through primary production in the host country	Lower labour costs Develop new sales markets Enhance competitiveness through primary production in the host country Secure potential sales markets Secure and cultivate existing sales markets Longer machine running times Longer working hours
IS	**1.56**	**1.88**	**1.84**	**1.70**
1.50 **low** 1.00 0.50	Lower labour costs Lower tax burden Better purchasing and procurement possibilities Longer working hours Fewer administrative impediments Longer machine running times Less stringent environmental constraints	Lower tax burden Longer working hours Overcome import barriers Better purchasing and procurement possibilities Longer machine running times Fewer administrative impediments Less stringent environmental constraints	Fewer administrative impediments Overcome import barriers Lower tax burden Better purchasing and procurement possibilities Longer working hours Longer machine running times Less stringent environmental constraints	Lower tax burden Better purchasing and procurement possibilities Fewer administrative impediments Overcome import barriers Less stringent environmental constraints

Source: Mollers, "Foreign Direct Investment in Ukraine–Experiences Taken from Reality" (1998)

The GAG study uses the matrix to discuss how the set of location advantages differs across countries. From the investor's point of view, Ukraine exhibits a similar profile as Russia, where market-seeking activities dominate. However, across all CEE countries, lower labour costs turn out to be ranked third, because the sample now includes countries which are more successful in market reforms than Ukraine. What is more, in the case of the Czech Republic, where reforms are already at a very advanced stage, low labour costs become the key motive, even though they are considerably higher than in Ukraine. Thus, if investors perceive the Czech Republic as exhibiting a labour cost advantage, then it is even more evident that impediments to raising productivity in Ukraine significant outweigh the cheap nominal cost of labour.

This claim is also supported by the study's ranking of "enhancing competitiveness through primary production" as almost as important a motive for relocation to the Czech Republic as market-related motives. However, for Ukraine and Russia this aspect is of no more than secondary importance, though, again, labour costs are lower than in the Czech Republic.

Type-Specific Peculiarities

Looking at the survey results from the point of view of type-specific peculiarities, some striking differences appear in the attitudes of different investor types. The relative importance of the ready availability of cheap input factors, including labour, is much higher for entrepreneurial than for other groups of investors. For entrepreneurial investors, cheap inputs rank second in importance (AR=1.67), being surpassed only by market size and its potential growth. This may be explained by the fact that entrepreneurs, being small/medium-size investors, are highly sensitive to cost factors. It also shows that entrepreneurial investments are typically one-country ventures, and as such are not part of a larger strategy. Entrepreneurs, therefore, usually disregard other market considerations (e.g., regional markets, etc.).

It is also interesting to note that the importance of improving competitiveness in supplying established markets from lower-cost originations is much higher for MNEs (1.91) than for the sample as a whole (2.53). It is explained by the MNEs' tendency to try to raise the efficiency of their operations through production in the most cost-efficient place and subsequent export to other markets.

Ukraine's Cheap Labour: A Myth?

The fact that cheap labour was not found to be a prominent motive for investing in Ukraine deserves more attention, as Ukraine's attraction in this regard is a common theme in describing Ukraine's merit as an FDI recipient. It shows that we need to distinguish between nominal wage levels and total labour costs, which also take into account labour productivity, cost of regulatory interventions, and other factors.

The impact of low labour productivity is clear. Due to a lack of capital, necessary training, and inferior management, labour productivity in Ukraine is often so low that total labour costs end up higher than in other Eastern European countries. However, some careful distinctions need to be drawn in this regard, as labour productivity seems to differ drastically between (1) situations in which foreign investors acquire existing factories burdened with huge stocks of unused capital and labour, and (2) situations in which foreign investors build new factories, supply modern equipment, and train workers.

Since new owners cannot quickly lay off or re-train several thousand people simultaneously, labour productivity tends to be much lower in acquisition situations. Local authorities, concerned with maintaining employment levels, usually put constraints on headcount cuts, thus drastically raising total labour costs. In addition, foreign investors are also sometimes obliged to inherit the social infrastructure of large industrial complexes; including hospitals, kindergartens, summer camps, farms, greenhouses etc.

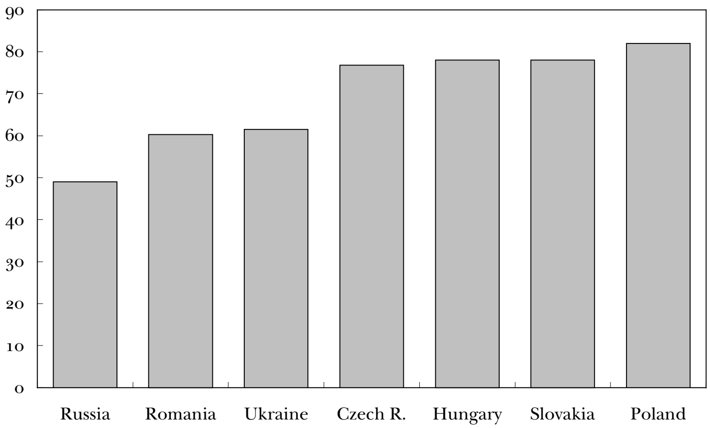
These obstacles erode the cost advantage of cheaper labour by making production more difficult and expensive. However, where foreign investors build operations from scratch, Ukrainian workers often perform no worse than their Western counterparts.

Risk versus Reward in Ukraine

The driving force of any investment is the expectation of the resulting financial rewards. The expectation of rewards is directly proportional to the anticipated risks of the investment project, i.e., the riskier the project, the higher the required return needs to be.

From the target point of view, the risk profile of a project can be broken down into country-specific risk, sector-specific risk and project-specific risk. The country risk is the base risk component. Unfortunately, in most recent risk ratings, Ukraine stands out as one of the most risky countries in the CEE region, meaning that investors should anticipate a high probability of failure.

Country Risk: Composite ICRG Risk Rating



Note: Composite International Country Risk Guide (ICRG) risk rating is an overall index, ranging from 0 to 100, based on 22 components of risk. The closer the index approaches 100, the lower the country risk is.

Source: The World Bank, 1999

From the investor's point of view, their cost of capital defines the threshold level of return. Projects with a return below the threshold would be value-destroying. In order to maximize shareholders' value, investors would normally pursue projects, which promise a higher return than their cost of capital. The required return needs to incorporate the anticipated risk premium of the project (as discussed above). A company which enjoys a relatively low cost of capital, will therefore typically require a lower return on its investments than one with a higher cost of capital. Since a company's cost of capital ultimately depends on a firm's ability to raise capital by means of debt and/or equity, companies with easy access to capital will require lower returns on their investment projects than companies with less easy access to capital. One may therefore expect that global multinationals, typically well-capitalised companies, would be satisfied with lower expected returns than local investment funds or entrepreneurial ventures.

This expectation is supported by the survey results. One question in the survey questionnaire asked investors to state the internal rate of return (the discount rate that turns the project's cash flows into zero net present value) they would expect from an investment project in Ukraine. The surveyed were asked to choose among the following IRR ranges (defined in constant US$ terms): <10%, 10–20%, 20–30%, >30%.

Expected IRR of Investors

%

IRR (real US$)	MNEs	Entrepreneurial	Institutional	Multilateral	TOTAL
<10	10			50	10
10–20	50	25	20	100	43
20–30	30	75	40		38
>30	10	25	40		19

Note: some investors have targeted more than one IRR range

Source: Flemings/SARS survey

The vast majority of respondents (some 80%) required IRRs within the 10–30% range. Judging by their risk appetite, multilaterals appear to be the most resilient investors, followed by MNEs, while institutional and entrepreneurial investors are more risk-averse.

As can be seen from the table above, only MNEs and multilaterals can afford IRRs of less than 10% owing to their prime creditworthiness, which allows them to keep their cost of capital at single-digit levels. Most of them target IRRs of 10-20%, which is modest considering Ukraine's high country risk. As expected, entrepreneurs and investment funds require higher returns: 75% of entrepreneurial investors and 40% of institutional respondents target IRRs of 20–30%. 40% of institutional investors and 25% of entrepreneurial investors require more than 30% IRR, versus only 10% of MNEs. Across all investor types, the vast majority of respondents (some 80%) required IRRs within the 10–30% range. Judging by their risk appetite, multilaterals appear to be the most resilient investors, followed by MNEs, while institutional and entrepreneurial investors are more risk-averse.

Investors' Decision-Making Process: Time Horizon and Complexity

Owing to their differences in size and organisational structure, different investor types exhibit dissimilar decision-making patterns. When asked about the typical time period for an investment decision (from the moment when a specific investment opportunity is identified to the final decision) and the number of decision makers involved, our investor sample gave the following answers.

Decision-Making Period and Number of Decision-Makers

%

Time period	MNEs	Entre-pren.	Institu-tional	Multi-laterals	Total
Less than month	0	25	0	0	5
1–3 months	20	0	20	0	14
3–6 months	30	25	60	50	38
More than 6 months	50	50	20	100	48
Avg # of deci-sionmakers	4	3	5	Board	4

Note: some investors have checked more than one time period

Source: Flemings/SARS survey

The decision-making period for an investment in Ukraine takes more than 6 months. Few entrepreneurial investors can decide on an investment in less than a month.

The table shows that even for entrepreneurial investors, the decision-making period for an investment in Ukraine takes more than 6 months. Only a few entrepreneurial investors can decide on an investment in less than a month. Over half of the survey respondents can commit to a direct investment within 6 months.

The results of the survey confirm our intuitive assumptions. Large (hence organisationally complicated) multinationals tend to be less flexible and take more time in identifying, developing and approving investment projects. MNEs, as well as institutional investors (multilaterals included), normally would not pursue an investment without a thorough due-diligence process, which may take from one to several months. By contrast, private entrepreneurs can make investment decisions without consulting internal hierarchical structures, and without complete information on the investment project. Therefore, they can make investment decisions in a shorter time period than large multinationals or investment funds.

Investment funds, which typically have local representation in Ukraine, spend their time only on the project specific research and due diligence. They are already aware of the local environment. As a consequence, they have a shorter decision-making period than newly entering MNEs and entrepreneurial investors. At the same time, the involvement of a larger number of decision-makers makes it difficult for institutional investors to come up with a decision in less than 3 months.

Multilateral donor organisations have the longest investment horizon, since their investment decisions are taken not only in a commercial but also in a political context. Their investment decisions are often largely dependent on policies established by local governments. If these policies are in line with multilaterals' preferences, then investment decisions will be approved. Otherwise, they can be postponed indefinitely or cancelled altogether. Multinationals also typically have a far more complicated organisational structure, and their procedures are more rigid; therefore, their decisions demand more time.

Deterrents to FDI in Ukraine

Given its importance, a question in the survey asked foreign direct investors already fully operational in the Ukrainian economy to identify and evaluate the main problems encountered by them in making and operating investments in Ukraine. An overview of their answers is given below:

Impediments to Investment in Ukraine

Rank	Obstacles to Investment	Average Response				
		MNEs	Entre-pren.	Institu-tion.	Multilat.	Total
1	Instability and exorbitance of the regulatory environment	1.0	1.5	1.0	1.0	1.03
2	Ambiguity of the legal system	1.1	1.7	1.5	1.0	1.21
3	Uncertainty of the economic environment	1.1	2.0	1.25	1.0	1.27
4	Corruption	1.2	2.0	1.4	1.0	1.34
5	High tax burden	1.45	1.75	1.5	1.5	1.46
6	Problems establishing clear ownership conditions	1.55	1.3	2.4	1.5	1.56
7	Depressed disposable income levels	1.5	1.7	2.25	1.5	1.69
8	Difficulty of negotiating with government/privatisation authorities	1.6	1.7	2.5	1.5	1.78
9	Volatility of the political environment	1.5	2.3	2.0	1.5	1.82
10	Lack of physical infrastructure	2.2	2.0	2.0	2.0	2.09
11	Problems in accessing domestic and export markets	1.8	1.7	2.75	2.5	2.16

Note: 1 = 'major problem'; 2 = 'minor problem'; 3 = 'not a problem'. Source: Flemings/SARS survey'

The survey showed instability and exorbitance of the regulatory environment as the #1 deterrent to FDI, followed by ambiguity of the legal system, uncertainty of the economic environment, and corruption.

Strikingly, all of the typical obstacles to FDI identified in the literature are found in Ukraine and are considered significant by foreign direct investors. Even the one found least important, i.e., "Problems in accessing domestic and export markets", has an AR in Ukraine of 2.16. This indicates that it is still found to be an impediment, though of relatively minor significance compared to the others.

The survey showed "Instability and exorbitance of the regulatory environment" as the #1 deterrent, followed by "ambiguity of the legal system", "uncertainty of the economic environment" and "corruption". It is worth noting that, unlike other investor groups, entrepreneurial investors ascribed a lower significance to these factors. This may be explained by their greater ability to adapt to local business standards.

"High tax burden" ranks next on the list of Ukrainian disadvantages. "Problems associated with establishing clear ownership conditions", "depressed disposable income levels" and "difficulty negotiating with government/privatisation authorities" are also seen as impediments by investors, though they are less significant for private and institutional investors. At the same time, problems with establishing clear ownership conditions are of relatively higher significance for entrepreneurial investors (AR=1.33), presumably because smaller investors are more vulnerable to the kind of uncertainties which unclear ownership conditions may evoke[6].

"Volatility of the political environment", "lack of physical infrastructure", and "problems in accessing domestic and export markets" conclude the list, with 'minor problem' ranks. Market access again turned out to be a bigger problem for investors directly involved in production activity (i.e., MNEs and entrepreneurial) while political instability is of more concern for MNEs and multilateral financial institutions. Interesting to note that investors ranked problems associated with exporting their products to potential new markets as of minor significance, not because of the scarcity of impediments to exports in Ukraine. This is rather due to the lack of export-oriented activities, which are typical for resource-

[6] This finding is also supported by evidence from a recent study conducted under the aegis of Ukrels and entitled "Enterprise Land Privatisation: Appraising the Impact on FDI in Ukraine". The study, which is also found in this issue of **Policy Studies**, states that entrepreneurial investors are the most sensitive to the status of land privatisation in Ukraine.

seeking and efficiency-seeking investment. Again, this finding indirectly confirms the prevalence of market-seeking investment activities in Ukraine.

In what follows, we give more detailed explanations of the impediments to FDI in Ukraine.

Taxation

Punitive and unpredictable taxation is often seen as a substantial impediment to doing business in Ukraine. Although taxes in Ukraine currently take the usual forms of corporate, personal, and VAT taxes, the levels of these taxes are excessive; for example, the business payroll stands at over 50 percent. To make things worse, exemptions are applied in an arbitrary and unpredictable fashion. Tax avoidance is widespread, as are the bribery and corruption associated with tax avoidance. The underground, “shadow” economy has mushroomed from about 12% of economic activity prior to independence to more than 60% now. By definition, none of this informal activity is taxed.

A costly side-effect of the shrinking tax base is that private enterprises (not to mention individuals) avoid the banking system, since bank deposits would expose them to tax collection. In Ukraine, the broadly defined money supply, M2, is only 12% of GDP. This constitutes only a fraction of the levels of any but the world's least developed economies. This means that Ukraine is effectively a cash and barter economy, with all the usual costly consequences for doing business. Another consequence of tax avoidance is that firms are biased toward inefficiently high capital expenditures in an effort to minimise reported profits.

Foreign investors cannot expect to evade taxes alongside the underground local enterprises. On the contrary, foreign investors are typically treated as highly visible and vulnerable cash cows. They can expect to pay not only legitimate, preannounced taxes, but also ad hoc assessments and bribes that depend on the power of particular government officials to block their activities. This is a part of a wider pattern of government interference.

Government Interference

Ukrainian managers spend a significant amount of time dealing with government officials regarding taxation, licensing, and related matters. Private firms spend more time on this than do state-owned enterprises. Projects sponsored by international financial institutions are not immune to government interference. For example, we were told that an EBRD-financed agricultural services project has been subject to 28 external tax audits in the last 18 months. Real estate development can be particularly difficult; in Kyiv, it can take two years from the first application to the receipt of formal approval. Applications by both Hilton and Marriott hotels remain on hold, while hotel facilities in Kyiv remain inadequate. Obstacles arise from a plethora of agencies, including tax authorities, the customs service, the ministries of finance, and economy, and local authorities.

Changing Laws

In the absence of a new Civil Code, existing legal ambiguity is compounded by the uncertain precedence of one enactment over another. A common problem is that licensing and regulatory requirements are not only unclear at the outset of a project, they also invariably change and multiply as project development proceeds. Even worse, new regulations are often applied retroactively, thus significantly raising investment risks.

Customs

Most complaints against the customs clearance procedure refer to the legal uncertainties surrounding it. New regulations not yet published, or published only the previous day, are immediately put into practice by the customs authorities. In many cases, this leads to delays lasting several days, making deliveries headed for Western Europe less and less attractive to customers, and causing costly idle times for companies in Ukraine waiting for consignments of spare parts, etc. The list of goods subject to customs duty is constantly altered, making every delivery a matter of luck—have all the papers been obtained or does some confirmation or other still have to be taken to the border, as so frequently happens?

The customs authorities' arbitrary behaviour seriously impacts the investment climate in Ukraine. There is evidence of a number of cases which resemble the following one: after an investor had imported his basic product from abroad without having to pay customs duties for ten months, the country in question was suddenly put on the list of countries from which imports were liable for duties.

Corruption, Crime, and Unenforceable Contracts

Corruption follows directly from the degree of discretion officials have in granting approvals for private business. In Ukraine, unofficial payments have to be made at all stages of the licensing and permission process. Once again, it is local officials who are particularly notorious for extracting bribes, often to waive regulations that have already been abolished by the central government.

Policy Agenda to Enhance Ukraine's Attractiveness for FDI

Given the numerous concerns voiced by foreign investors over the deterrents to FDI in Ukraine, we felt it useful to ask investors to provide their views on the policy agenda for the Ukrainian government. For this purpose a section of the questionnaire included questions about what should be done by the Ukrainian government to improve Ukraine's attractiveness for FDI.

The table below summarises the responses received. The numbers in the table represent average scores (from "1—a top priority" to "3—not a priority"), assigning relative significance to certain policy moves.

What Should Be Done to Enhance Attractiveness of Ukraine for Foreign Investors?

	Policy actions	MNEs	Entrepreneurial	Institutional	Multilateral	Total
1	Liberalise capital, forex and profit repatriation controls	1.1	1.25	1.4	1	1.12
2	Lift restrictions on foreign ownership and control	1.1	1.25	1.6	1	1.16
3	Minimise red tape	1.5	1	1.2	1	1.17
4	Reduce tax rates and in number of taxes	1.4	1	1.6	1	1.32
5	Lift restrictions in accessing domestic and export markets	1.5	1.5	2.2	2	1.78
6	Enhance the contract enforcement system	1.6	1.75	2	2	1.81
7	Equalise domestic and foreign investors in treatment by the Ukrainian government	2	1.5	1.8	2	1.92
8	Improve physical infrastructure	1.8	2.25	2.4	1.5	1.97
9	Increase trade barriers for imports	2.4	2.75	2.8	2.5	2.62

Source: Flemings/SARS survey

As can be seen from the aggregated responses, the liberalisation of capital, foreign exchange and profit repatriation controls; the lifting of restrictions on foreign ownership and control; and minimisation of red tape and reduction in tax rates and in the overall number of taxes are considered to be primary actions which should be undertaken by the government. All types of investors are virtually unanimous in ranking these issues. Only small discrepancies arise between the MNEs and other groups of investors in ranking the various issues. Whilst the MNEs give priority to liberalisation of capital, forex and profit repatriation controls, and lifting of restrictions on foreign ownership and control, other groups (both institutional and entrepreneurial) are more preoccupied with the minimisation of red tape, reduction in tax rates, and in the number of taxes. This difference can probably be attributed to superior MNEs bargaining power over entrepreneurial and private institutional investors.

The liberalisation of capital, foreign exchange and profit repatriation controls; the lifting of restrictions on foreign ownership and control; and minimisation of red tape and reduction in tax rates and in the overall number of taxes are considered to be primary actions which would be undertaken by the Ukrainian government. All types of investors are virtually unanimous in ranking these issues.

Being directly involved in production and distribution activities, MNEs and entrepreneurs both expressed concern over market access, as they are often constrained in their sales decisions.

It was surprising to find that such frequently cited FDI incentives as equal treatment of foreign investors, enhancement of infrastructure, and increase in import barriers are perceived to have relatively low priority for Ukraine's policy agenda. Within this low priority group, multilaterals and MNEs attach more importance to infrastructure-improving policies. Entrepreneurial investors, who have limited capability to protect their rights, attach more importance to equalisation of rights.

Role of Privatisation in Attracting and Sustaining FDI

Since the status of privatisation was found to be an important factor in attracting FDI flows to countries in transition, the questionnaire asked about its perceived importance in Ukraine. As anticipated, the status of privatisation was found to be significant in the overwhelming majority of cases. Only 5% of the respondents (deep-pocketed MNEs) found privatisation status to be unimportant in their activity. For the rest of the investors (95%), privatisation policy appears to be a crucial factor, which affects their investment decisions (see table below).

The status of privatisation was found to be significant in the overwhelming majority of cases. Only 5 % of respondents found the privatisation status unimportant in their activity.

Significance of Privatisation Status for Investment Decisions

%

Significance	MNE	Entrepr.	Institutional	Multilateral	Total
Very significant	60	33	40	100	55
Significant	30	67	60		40
Insignificant	10				5

Source: Flemings/SARS survey

Privatisation is generally perceived as benefiting the national economy and local business in various ways: through enhancement of productivity, reduction of unproductive government interference in the economy, etc. Foreign investors who participated in the survey were asked to describe how privatisation would benefit their investment policies in Ukraine. The table below summarises their replies.

Perception of Benefits from Privatisation

%

Benefits from privatisation	MNEs	Entrepreneurial	Institutional	Multilateral	Total
New acquisition opportunities	13	67	80	50	44
Enhanced business climate	100	33	100	100	89

Note: some investors have checked more than one reason

Source: Flemings/SARS survey

The importance of privatisation in opening up acquisition opportunities was acknowledged by most institutional (private and multilateral) and entrepreneurial investors surveyed. It was surprising to compare this result with the previous findings, which showed that MNEs do not rely much on privatisation in structuring their entry. The reason may be that either there are not many companies in the privatisation pipeline which MNEs would consider worth acquiring or that they do not believe that the privatisation process would be transparent.

The majority of respondents see the most important role of privatisation in the enhancement of the overall business climate, given that privatisation favours efficiency.

Policy Recommendations

The survey findings imply an array of recommendations for Ukraine's FDI policy. Yet, in order to avoid recommendations in broad and, therefore, ambiguous terms, we focus on concrete steps the Ukrainian privatisation agency, the State Property Fund (SPF), can undertake to facilitate FDI inflow.

Given that market seeking is a dominant drive of foreign investors coming to Ukraine, policy should target lower entry barriers. Having still many lucrative enterprises in the pipeline, Ukrainian privatisation has the possibility to tap a deep pool of FDI, where best-practice foreign firms would prevail.

Given that market seeking is a dominant drive of foreign investors coming to Ukraine, policy should target lower entry barriers. Provided a transparent and smooth privatisation procedure, as well as availability of suitable acquisition targets, entry through privatisation offerings (e.g., acquisition of majority stakes in target enterprises via tender) should take less effort from investors than development and implementation of green-field projects. In order not to distort this common sense, the SPF should ideally become the only authority to deal with, and the only decision-maker on privatisation terms and methods. The recently launched administrative reform might help with achieving that end, as a number of agencies with overlapping authority were liquidated (e.g., National Agency for Management of Corporate Rights). Given that most investors need more than 6 months to come up with investment capital, saving time on fixing terms and negotiating with privatisation authorities should be worthwhile. In addition, it might be more effective and efficient to focus efforts on reducing red tape and containing corruption within the SPF rather than disperse efforts in trying to fight those problems countrywide and across different government levels.

The transparency of privatisation procedures should also make ownership rights clearer. Though it is also a function of the broader legal and judicial framework, adoption of sales procedures that avoid creating collusion clauses, which may be challenged later, should make investors feel more comfortable about their ownership titles. Here, the SPF has to demonstrate integrity and consistency. The resulting simplification of dealing with Ukrainian privatisation authorities, and greater clarity of ownership status, should translate into better bid valuations (owing to lower risks), as well as make privatisation offerings accessible to a wider pool of investors.

The study also implied that prime MNEs, as best-practice firms and deep pockets, should be targeted as investors for Ukraine, which faces enormous restructuring and investment needs and desperately needs revenues for the state coffers. MNE modest IRR demands potentially open a wider spectrum of enterprises/projects for investment. To tailor the SPF's privatisation policy and methods to MNE preferences, we recommend the following:

- Given the prevalence of market seeking as the driving investment motive, the SPF should focus on sectors with a sufficiently large and growing domestic market: food sector and telecoms.
- Terms of privatisation sales should avoid constraints on staffing levels, since that keeps labour-seeking motives out of play. This should apply especially for labour intensive sectors like textiles and apparel, and some subsectors of engineering.
- Though benefiting from the low cost of capital, the discount rate in valuing Ukrainian targets is highly unlikely to fall below 10% in real US dollar terms. SPF officials should learn the basics of the DCF (Discounted Cash Flow Analysis) assessment approach to come up with realistic offer prices (or alternatively, hire reputable professionals to do assessments).
- The SPF should also understand that attachment of investment commitments to tender terms is irrelevant in getting a better price for the offered stake. Frequently, those investment requirements are excessive and inappropriate (might be value-destroying) since a best-practice MNE should know better how to spend its money effectively and efficiently. In addition, by logic of the net present value, those investment commitments reduce the price of the stake per se. For the sake of transparency, a privatisation offering where bidders compete only on price without facing some fixed investment requirements, should be a preferable option. A firm (most likely to be on MNE) which is the most efficient in running the enterprise to be sold should anticipate the highest stream of earnings, and thus should be able to submit the highest bid.
- Given the complexity of MNE decision making, the privatisation offering should allow enough time for proper evaluation of the target firm and due diligence, i.e., it should optimally allocate 3–6 months.
- Prior to privatisation offering, the SPF should ideally clear the ground from legal, regulatory, and other uncertainties by pressing relevant agencies for the desired amendments. Much of the uncertainties would be eliminated if the SPF offers majority stakes (ideally 75%+1), or at least allows interested investors to accumulate such a

stake (i.e., the stake retained in state ownership should not exceed 50%).

Foreign investors would certainly evaluate their possible investments in Ukraine in a broader context, not just according to the merits and faults of its privatisation policy. However, having still many lucrative enterprises in the pipeline, Ukrainian privatisation has the possibility to tap a deep pool of FDI, where best-practice foreign firms would prevail.

Enterprise Land Privatisation: Appraising Its Impact on Foreign Direct Investment in Ukraine

Preface

This study investigates whether or not land privatisation status is a consideration for foreign direct investment (FDI) decisions in Ukraine. The analysis also estimates the possible benefits of more FDI resulting from progress in privatisation of Ukraine's non-agricultural land. This research was originated and sponsored by the USAID-funded Ukraine Enterprise Land Sales (Ukrels) Project. Ukrels commissioned Velox Company, a US-based consulting firm specializing in investment research and advisory, marketing, and management consulting in Ukraine, to undertake the study and prepare this report. Velox's research team comprised Vitali Nosov, Alina Kudina, and Dmytri Lohvynenko.

The study is based on a survey conducted by Velox Company in November–December 1999, covering 31 foreign investors who entered or sought to enter Ukraine's market.

The authors of this report are grateful to all respondents for their cooperation and valuable input to this study. Our special thanks go to Mr. Johann Boden (Chumak/South Food), Mr. Patrick Bracken (Cargill), and Mr. Jack Liczkowski (Bestfoods) for their prompt and thoughtful replies and comments.

Executive Summary

Land ownership is never explicitly mentioned as an FDI motive in the mainstream literature on FDI. Yet the issue of land privatisation in transition economies, and Ukraine in particular, does fit in the orthodox framework of FDI motives, as it helps to limit the risks of governmental intervention and political/regulatory instability. The stylised empirical evidence across CEE/CIS, and bottom-up evidence of other studies are supportive of a positive link between land tradability and the level of FDI in a recipient country.

By undertaking a survey of 31 foreign firms who invested or intend to invest in Ukraine, the study attempted to reveal the empirical evidence for the following two hypotheses:

1) In a transition economy setting, land tradability, achieved by land privatisation, has a positive impact on FDI inflows. The less limited land tradability is, the more FDI are going to flow in.

2) When investing in sectors/enterprises where production is more land-intensive, foreign investors are going to be more sensitive to land tradability/ownership than in case of those with a negligible role of land in the production process.

The survey findings yielded generally supportive results for both assumptions. However, the former did not have uniform empirical support: the study showed that land status has the greatest importance for smaller firms working in a sector where land is an important input (either direct or indirect), while the significance of land ownership is weaker for global multinational enterprises (MNEs), especially when their activities are not much related with land. The second hypothesis has found significant support in the survey data, though, again, large MNEs appear to be less sensitive to the issue.

The study also proved that most foreign direct investors in Ukraine would vote in favour of land privatisation, anticipating either direct or indirect enhancement of their business climate, while some would also respond with an increase in their FDI commitments to Ukraine. In other words, a rigorous effort of the Ukrainian authorities to boost land privatisation should pay off in higher FDI inflows.

Introduction

Since the being of its economic transition, foreigners have viewed Ukraine as an unattractive place to invest. In addition to excessive regulations, frequently changing legislation, and lack of transparency, the stalled issue of land privatisation is frequently cited among impediments to foreign direct investments in Ukraine. The fact that Ukraine, known for its fertile soil, has a natural comparative advantage in land-intensive agriculture and food-processing sectors, which together make up over 20% of GDP, makes the issue of land privatisation even more acute.

In this regard, a study was undertaken of the impact of land ownership on foreign investors' decisions to set up their business in Ukraine. The study was based on a survey of senior executives of foreign companies which are either operating or represented in Ukraine. While about 50 companies were approached, the final survey sample included 31 respondents, what is enough to draw general conclusions.

The main body of this report includes five chapters. The first chapter ('Ukraine's Status Quo With FDI and Land Ownership') reviews Ukraine's record and patterns in attracting FDI and describes the current status of land tradability. The second chapter 'Conceptual Framework and Hypotheses' presents theoretical background, and formulates a number of testable hypotheses regarding the impact of land privatisation status on FDI. The third chapter 'Data and Survey Methodology' describes the sampling methodology and survey approach, along with the sample profile. In the fourth chapter 'Survey Findings', the formulated assumptions regarding the significance of land privatisation status for non-agricultural foreign firms are tested by empirical evidence revealed in the survey. The final chapter 'Conclusions' summarizes the study findings, as well as infers policy implications for Ukraine in the realm of enterprise land privatisation.

Ukraine's Status Quo with Land Ownership

So far, Ukraine has not developed full tradability of land, as a prevailing number of local decision makers regard it as a taboo issue. However, over the last year Ukraine has exhibited some progress, which resulted in the start of small-scale privatisation of enterprise land.

Before we dwell on the link between land ownership and FDI, let us review the current status of Ukraine's land privatisation. So far, Ukraine has not developed full tradability of land, as a prevailing number of local decision makers regard it as a taboo issue. However, over the last year Ukraine has exhibited some progress, which resulted in the start of small-scale privatisation of enterprise land.

The minimum but sufficient legal justification entitling enterprises to privatise their land in use was established by a presidential decree issued back in July 1995. However, the Land Code adopted in 1992 explicitly allows only for sale of farmland under very restrictive, which that made this Decree vulnerable to challenges. The situation changed with the adoption of the new Constitution (June 1996), which has a clause guaranteeing individuals and enterprises the right to own land in accordance with legislation. Coupled with the presidential decree, this clause provided enterprises with a sufficient legal basis for buying land.

Nevertheless, until 1998 virtually no privatisation transactions with land took place. In 1998, enterprise land privatisation became observable, and resulted in sale of over 200 land slots valued at some US$2 million. As of late November 1999, the number of land sales (under the aegis of the Ukrels project) reached 1,385 raising UAH32 million (or under US$9 million)[7]. To date, the volume of land sales has not yet resulted in the emergence of a significant secondary market for land.

The process has been recently boosted by a presidential decree "On Sale of Non-agricultural Land Parcels For Entrepreneurial Activities" (January 18, 1999). Specifically, the decree explicitly gives individuals and firms the right to purchase land underneath their enterprises (including unfinished construction sites). The decree also envisages the option of market or expert assessment of land, as well as an option of long-term instalment payment, which should facilitate land sales.

Conceptual Framework and Hypotheses

Across the mainstream literature, land privatisation has never been mentioned as an issue of consideration for investors apart from agriculture, where land is the major production input. In the agricultural sector, land tradability is expected to create an incentive for higher efficiency (since land will have a price tag that would indicate the opportunity cost) and productivity (since land can be used as collateral for raising financing for agricultural producers).

So, why should land ownership status be a consideration for investors dealing with non-agricultural enterprises, where land is not a factor of production? Theoretically, an enterprise requires only an exclusive right to use the land slot it needs, which does not necessarily imply full ownership of that land; a lease arrangement should equally accomplish that end. The only strong case in favour of land ownership would be one when lease arrangements are proven to be fragile, i.e., they provide insecure rights of use. The source of the latter can be with one of the contracting parties, more specifically, with lessor. In former socialist economies, the state (represented either by municipalities or the central government) is the most frequent lessor, since it is the dominant owner of land. Thus, there should be some problems with the

[7] So far, most land sales in Ukraine have been arranged by the USAID-funded Ukrels project.

state/government as the lessor, which makes full ownership of land (through privatisation) a preferable option for private enterprises and investors.

A recent survey of over 3,000 firms in 20 transition economies, conducted by the EBRD in collaboration with the World Bank and reported in the *EBRD Transition Report 1999* has supported the idea that the state is a poor partner in Ukraine. First, Ukraine turned out to be the second-least (after Moldova) secure economy regarding property and contract rights: over 70% of surveyed firms reported doubts about the security of their contract/property rights. In contrast, less than 30% of surveyed firms in Hungary and Poland had similar concerns[8]. This might explain why more certain full ownership of land should be a superior option in Ukraine. Indeed, to date, a significant share of land privatisation deals in Ukraine has been made by firms who wish to switch from 'permanent' lease rights to complete ownership.

One can formulate the following hypotheses: (1) in a transition economy setting, land tradability, which is achieved by land privatisation, has a positive impact on FDI inflows; (2) for a given enterprise or sector, the significance of land ownership status for FDI tends to rise with the significance of land as a (direct or indirect) factor of production/service.

The EBRD survey also revealed that private firms face much less frequent state interference than state-owned firms do. Ukrainian firms also reported more frequent state interference than Polish, Russian, or Romanian ones did. Thus, privatisation of land reduces the grounds for state interference, which frequently has an adverse impact on foreign investors.

Formulation of Testable Hypotheses

The stylised empirical evidence (sourced from the *EBRD Transition Report 1999*) does point to a positive relationship between the tradability of land and FDI. The data plot below illustrates the point. However, it implies that the relationship is not that strong[9].

Based on the EBRD data, we opted to group transition economies into two categories: the first group comprises the countries (Ukraine included) where land is not tradable (de jure and/or de facto), and the second group includes countries where land is tradable (with or without restrictions for foreigners). The small sample size (24 countries) does not allow for a meaningful classification into more than 2 groups.

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[8] *EBRD Transition Report 1999*, p. 117

[9] One should be cautious about drawing conclusions from this data plot, due to the small number of observations and its oversimplification.

Why Has Kyiv Lacked Luxury Hotels for So Long?

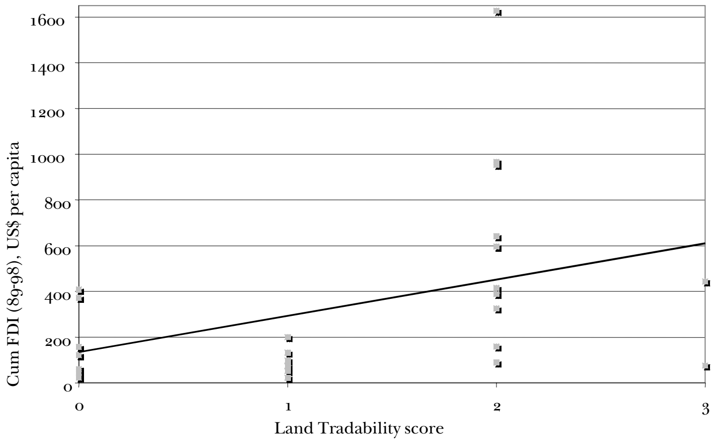
Kyiv has a reputation as the only capital city in Europe that does not have a single five-star hotel. The situation might look paradoxical, since there is sufficient demand for a luxury hotel service and there are many projects to build such hotels, backed by respectable foreign investors.

Those projects typically rely on long-term leasing of a land parcel in Kyiv, and here many problems arise. Firstly, hotel project developers encounter legal ambiguities regarding who is authorized to be a lessee of a land parcel. For example, the stagnant Ukrainian legislation may not provide for any definitive allocation of specific parcels of land between state and municipal ownership. Before that, for an investor it would be impossible to identify whether Kyiv State Administration (state ownership) or Kyiv City Council (municipal ownership) has the authority to lease a particular parcel of land or grant permanent use rights with respect to such land.

When approval of the right authority is secured, the story only begins. At a preparatory stage, the investor has to secure numerous documents from a number of City Administration departments; at pre-project stage the project design has to be approved by two local agencies; to secure location approval and reserve the site, the investor has also to submit a number of documents and win a number of consents; then the design undergoes revision and requires approval of over 15 bodies. After that, the Kyiv City Council adopts a decision to grant land use rights, though construction works require additional permits from a different authority. Rotation of mayors and re-elections of city councils can make the process even more challenging.

The cost of a stalemated 5-star hotel project typically runs to dozens of US$ millions and hundreds of job places, leaving aside the positive spillover effects for the local economy. Since 1992, the pipeline of stalemated hotel projects in Kyiv has exceeded US$300 million. As the description of the land allocation procedure above implies, the excessive red tape and non-transparency of land allocation rules are the main reasons for the stalemate. Those distortions would not likely exist under full ownership of land by investors since full title to a land spot would minimize room for governmental discretion and interference.

Cumulative FDI vs. Land Tradability



Source: EBRD Transition Report 1999, Velox Co.

Note: Land Tradability Score: 0=de jure limited tradability; 1=de facto limited tradability; 2=full tradability except foreigners; 3=full tradability:

For the first group (12 countries), the average FDI stock per capita was US$134 (here Ukraine, with US$52, still lags behind). The other group of 12 can boast average FDI stock per capita as high as US$557, or about 4 times more than that of the first group. While the difference in land tradability status is unlikely to capture the whole gap in FDI levels between these two groups of economies, there are grounds to believe that the issue of land ownership has a definite effect.

Based on this top-down observation, we can formulate the first hypothesis:

In a transition economy setting, land tradability, which is achieved by land privatisation, has a positive impact on FDI inflows. The less limited land tradability is, the more FDI are going to flow in.

Continuing the established logic, we can come up with another testable hypothesis:

For a given enterprise or sector, the significance of land ownership status for FDI tends to rise with the significance of land as a (direct or indirect) factor of production/service. In other words, when investing in sectors/enterprises where production is more land intensive, foreign investors are going to be more sensitive to land tradability/ownership than in case of those with a negligible role of land in the production process.

Groupings of CEE/CIS Countries by Land Tradability Status

De jure limited tradability of land

	FDI stock (89–98) US$ per capita
FYR Macedonia	121
Azerbaijan	408
Belarus	45
Kazakhstan	372
Russia	61
Uzbekistan	23
Average	**172**

De facto limited tradability of land

	FDI stock (89–98) US$ per capita
Albania	132
Romania	200
Georgia	98
Kyrgyzstan	72
Tajikistan	22
Ukraine	52
Average	**96**

Limited tradability of land

	FDI stock (89–98) US$ per capita
FYR Macedonia	121
Azerbaijan	408
Belarus	45
Kazakhstan	372
Russia	61
Uzbekistan	23
Albania	132
Romania	200
Georgia	98
Kyrgyzstan	72
Tajikistan	22
Ukraine	52
Average	**134**
SD	125

Full tradability of land (except foreigners)

	FDI stock (89–98) US$ per capita
Bulgaria	159
Czech Republic	967
Estonia	953
Hungary	1 627
Latvia	642
Lithuania	415
Poland	389
Slovak Republic	326
Slovenia	596
Armenia	89
Average	**616**

Full tradability of land

	FDI stock (89–98) US$ per capita
Croatia	444
Moldova	76
Average	**260**

Full tradability of land

	FDI stock (89–98) US$ per capita
Bulgaria	159
Czech Republic	967
Estonia	953
Hungary	1 627
Latvia	642
Lithuania	415
Poland	389
Slovak Republic	326
Slovenia	596
Armenia	89
Croatia	444
Moldova	76
Average	**557**
SD	428

Source: EBRD Transition Report 1999, Velox Co.

Data and Survey Methodology

Survey Approach

To test the hypotheses formulated above on the Ukrainian ground, we designed a survey of foreign investors. The survey was conducted by means of mail-out questionnaires and personal interviews with senior executives of foreign companies. While selecting the companies we tried to form a representative sample. We contacted 50 companies and ended up with 31 whose responses formed the basis of our study.

To test the hypotheses formulated above on the Ukrainian ground, we designed a survey of foreign investors. The survey was conducted by means of mail-out questionnaires and personal interviews with senior executives of foreign companies.

While selecting the companies, we tried to form a representative sample by taking into account type of industry, company size, country of origin, and the type of investment. However, the sample was deliberately selected with a biased toward those industries where land should be *a priori* important, e.g., food processing, catering, real estate/construction. Our sampling bias to food processing is also justified by its top ranking among Ukraine's sectors that attracted the largest amounts of FDI: this sector accounts for over 21% of the cumulative FDI in Ukraine. Other sectors of significant FDI weight—engineering, chemicals/pharmaceuticals—were also represented in the sample. On the other hand, we skipped a number of sectors which are significant in volumes of FDI in Ukraine—financial/insurance, communications, and some others—on the grounds that a priori land is likely to play a negligible role in their business.

We contacted 50 companies and ended up with 31 whose responses formed the basis of our study. The final sample is characterized by the following structure:

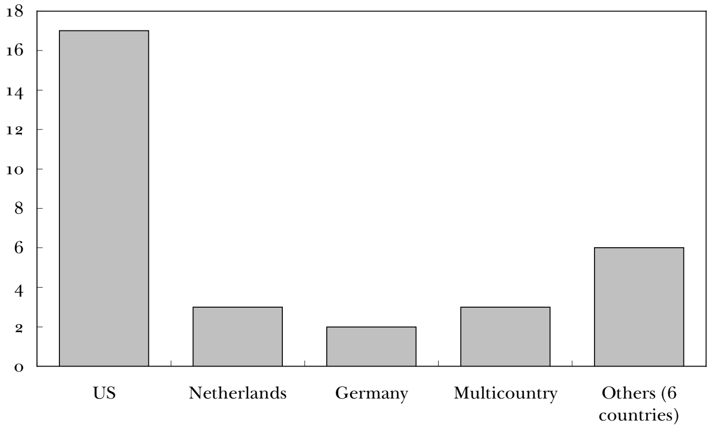
Foreign Investors: Survey Participants

Industry	Number of companies			
	Contacted		Replied	
	Number	% of total	Number	% of total
Food/Beverages/Catering	18	36	13	42
Chemicals/ Pharmaceuticals	8	16	4	13
Engineering	6	12	6	19
Real Estate/Construction	5	10	3	10
Multisectoral (direct equity funds)	5	10	2	6
Other/Miscellaneous	8	16	3	10

Sample Profile

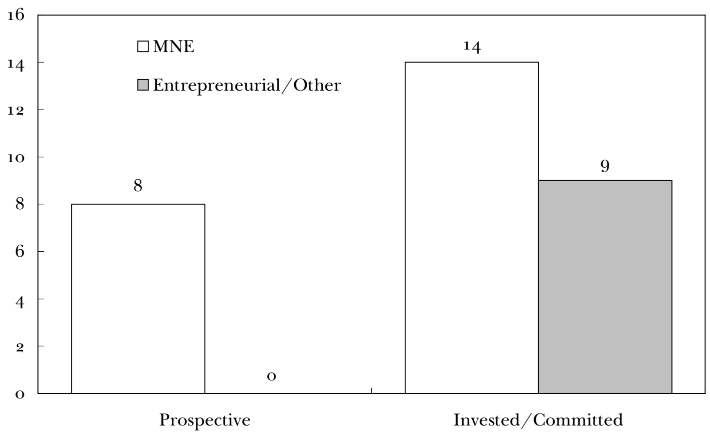
As of the date of the survey (December 1999), the firms of the survey respondents had invested or committed to invest over US$700 million what roughly represents one-fourth of the total FDI stock in Ukraine. In terms of country of origin, US firms prevail, which is consistent with statistics that indicates the USA as the #1 country of origin for FDI in Ukraine.

Geographic Distribution of Sampled Companies



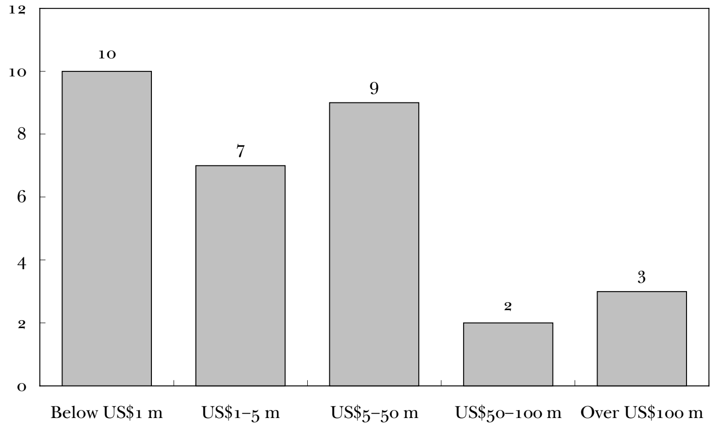
Our resulting sample is quite balanced between prospective and invested or committed investors, as well as between MNEs and entrepreneurial/other types of companies (except entrepreneurial types of firms among prospective investors).

Distribution of Sampled Companies by Type



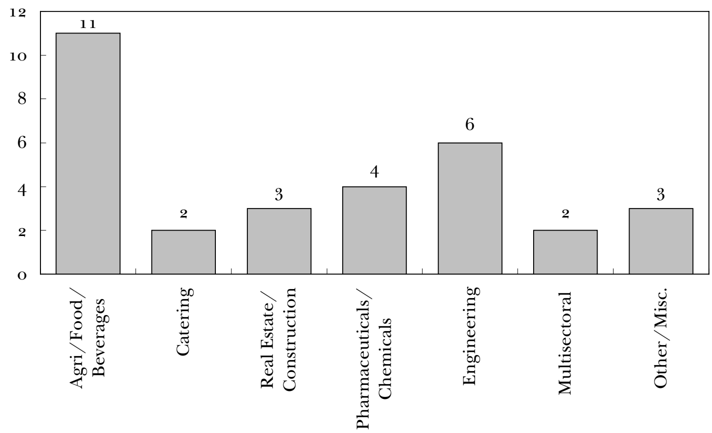
In terms of investment amounts, the sample seems to be representative across a wide spectrum of deals, though with a greater emphasis on small and medium investment sizes, which account for the majority of FDI inflows in Ukraine.

Distribution of Companies by Investment Size



As mentioned above, the sample was intentionally designed to have high weights for sectors where land is assumed to be important, i.e., food-related, real estate/construction. Such enterprises account for more than half of the final sample. One clarification is also in order here: Under the 'Multisectoral' category, we also incorporated two institutional investors who make direct equity investments into local enterprises from a diversity of sectors.

Distribution of Sampled Companies by Sector



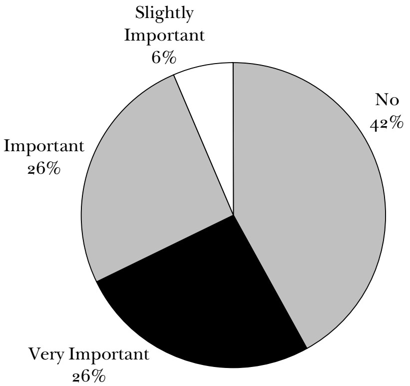
Survey Findings

Where is Land Important?

The majority of survey respondents (18 out of 31) acknowledged the importance of land in their business. As anticipated, food-related industries and real estate/construction indicated the importance of land in their business activity. It appeared that land bears some importance for pharmaceuticals and chemicals, as the former needs space for storage and retail outlets, while the latter can be interested in land if it contains a deposit of raw materials. Quite predictably, firms having higher involvement in agriculture (e.g., Cargill, Kyiv Atlantic, Chumak) give top importance to the role of land.

The majority of survey respondents acknowledged the importance of land in their business. As anticipated, food-related industries and real estate/construction indicated the importance of land in their business activity.

Is Land an Important Input in Your Business Activity?



Survey Participants

# of respondents

Investor types/ Sectors	Land-intensive	Other	Total
MNEs	11	11	22
Entrepreneurial/ other	5	4	9
Invested/committed	13	10	23
Prospective	3	5	8

To get a more meaningful idea about the survey findings, we attempted to identify patterns within our sample by grouping the respondents by investor type (multinational vs. entrepreneurial/other and invested vs. prospective) and sector (land intensive that includes food, agri, catering, beverages, real estate, and construction versus industries with low relevance of land as an input, e.g., engineering, chemicals, pharmaceuticals). Though numbers within groups are rather small to draw strong conclusions, we nevertheless proceed with this matrix.

Looking through this matrix, one might notice that within those 18 firms which admitted the importance of land for their business the majority is concentrated in land-intensive sectors. Horizontally, MNEs tend to ascribe smaller weight to the importance of land vis-a-vis entrepreneurial firms. This is probably due to the difference in bargaining power of a global multinational and a small entrepreneurial venture. In addition, land appeared to be a bit more important for committed investors vs. prospective ones. Here, we are reluctant to draw any conclusions, due to an asymmetry between these 2 groups: the group of prospective investors had none of the non-MNE types of firms. This bias in our sample might explain this difference.

Survey Respondents for whom Land is Important

percentage of respondents within groups

Investor types/ Sectors	Land intensive	Other	Average
MNEs	91	9	50
Entrepreneurial/ other	100	50	78
Invested/committed	92	20	61
Prospective	100	20	50

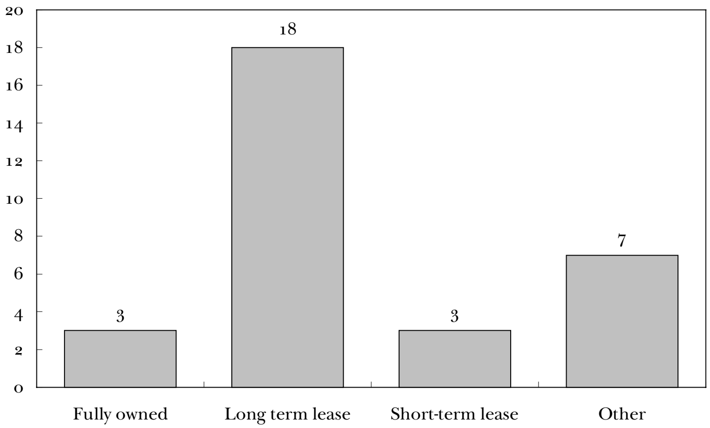
Willingness to Buy Land into Full Ownership

With respect to current land ownership status, the long-term lease turned out to be a prevailing form of land use for 58% of survey respondents. Three firms managed to secure full ownership of their land plots. Those which fall under short-term lease and other arrangements are mostly prospective investors who have not yet moved beyond establishing a rep office.

The survey respondents reported to be using in total over 18,100 hectares of land (not everyone reported), with few of them having a plan to buy it all into full ownership. Firms that depend on the performance of Ukraine's agriculture, e.g., food/agri processors, presented the strongest case for purchase of land. Some firms conditioned their wish to buy land on pricing (e.g., real estate/construction firms, direct equity funds). Overall, 8 out of 31 respondents reported their willingness to purchase land (over 3,100 hectares in total).

Among the 31 surveyed firms, the strongest preference for complete land ownership was expressed by smaller entrepreneurial firms (6 out of 9), while only 4 out of 22 MNEs indicated this preference. Predictably, firms in land-intensive sectors also exhibited greater willingness to purchase their land into full ownership. Again, firms which already have launched their business in Ukraine were more willing to buy their land plots (but keep in mind our sampling bias).

Distribution of Sampled Companies by Land Ownership Status



Respondents Who Preferred Full Land Ownership

percentage of respondents within groups

Investor types/ Sectors	Land-intensive	Other	Average
MNEs	27	9	18
Entrepreneurial/ other	80	50	67
Invested/committed	46	30	39
Prospective	33	0	13

South Foods/Chumak: A Successful Strategy

(Based on the questionnaire)

The Ukrainian business of Swedish Midnight Sun, Inc. was initiated beginning in 1994 in a few joint ventures throughout Ukraine. The main business, the South Foods company, was founded in the form of a joint venture with the State Property Fund (minority stake of 24%) in 1996. The brand "Chumak" was introduced in the fall of 1996. Today, the Chumak Group includes seven companies, in agriculture (1), processing (3), sales & marketing (1), transport (1), and catering (1). More than 1,400 people are working in the Group all year round, and during the harvest season the staff level increases up to 3,500–4,500 direct employees and over 5,000 additional workers indirectly involved. The total amount of investment in Ukrainian operations has already exceeded US$40 million.

The land appears to be a vital factor for Chumak operations. To date, the company has experienced difficulties in attracting investments in the local agriculture business. In addition, one of the best ways to finance agricultural operations is to be able to secure financing by land securities (collateral), which at this moment is not possible in Ukraine. Chumak's agriculture company is cultivating over 20,000 hectares with its own equipment and under its own management. The company has succeeded in signing long-term rental contracts (from 3 to 29 years, 10 years on average). According to Mr. Johann Boden, Managing Director of South Foods/Chumak, if they could have the possibility to purchase and own their land, the investments and size of operations would increase tremendously. Up to this moment, Chumak's limitations have not been the market but the availability of quality raw materials. They solve this problem by growing their own tomatoes, cucumbers, sunflower seeds, etc.

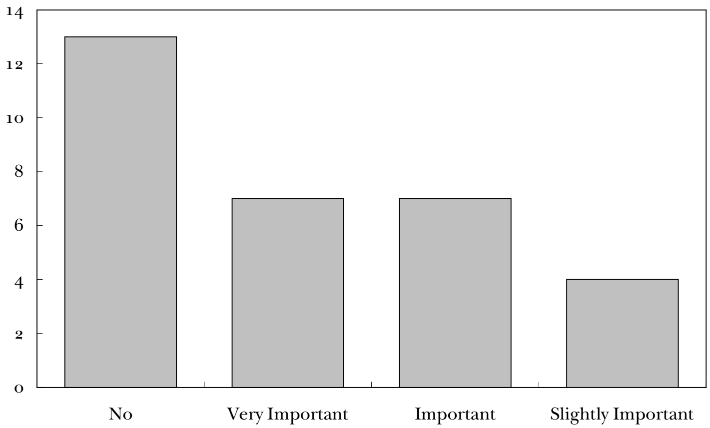
Currently, the company uses 12,000 hectares of land. For 2000, Chumak's target is to increase to over 20,000 hectares; for 2001, up to 35,000 hectares (depending on legislative developments). Chumak sees its long-term necessity (goal) as purchasing up to 100,000 hectares and cultivating them according to international standards, since their business is driven by agriculture. They believe that Ukraine has some of the best potential in the world in terms of agricultural production, and that is one of the key reasons they have established Chumak in Ukraine. To cite Mr. Boden, "It's self evident that land and land legislative reforms are of great importance for the future development and expansion of Chumak."

Impact on the Decision to Invest

Eighteen firms, or 58% of respondents, admitted the importance of land ownership status for their investment decisions, with 14 firms indicating its strong importance. The matrix presents the distribution of those 18 firms which acknowledged the impact of land ownership status on their decision to set up Ukrainian operations.

Eighteen firms, or 58% of respondents, admitted the importance of land ownership status for their investment decisions, with 14 firms indicating its strong importance.

Is Land Ownership an Important Consideration in Investment Decisions?



Importance of Land Ownership for Investment Decisions, by Type

percentage of respondents within groups

Investor types/ Sectors	Land-intensive	Other	Average
MNEs	91	18	55
Entrepreneurial/ other	100	25	67
Invested/committed	92	30	65
Prospective	100	0	38

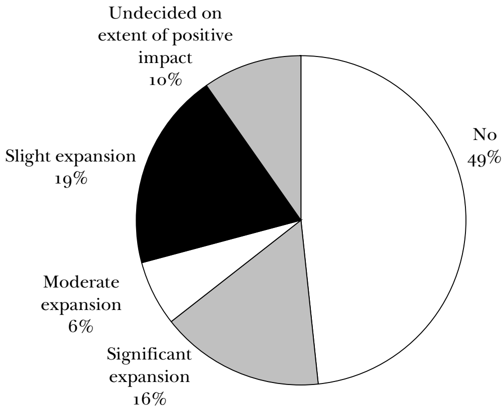
Again, firms in land-intensive sectors like food/agri processing, real estate, and construction were almost unanimous about the significance of land ownership for their investment decisions. On the horizontal dimensions of the matrix, entrepreneurial/other and committed/invested groups of firms were more likely to recognize the impact than the others. Yet within land-intensive sectors, prospective investors were at least as likely to recognize the significance of land ownership in their investment decision making as those who already committed their money to Ukraine.

Impact on Future Plans to Invest/Expand

Out of 31 firms surveyed, the majority (16) still indicated that easy land privatisation would boost their activity in Ukraine.

Out of 31 firms surveyed, majority (16) still the indicated that easy land privatisation would boost their activity in Ukraine. Some of the firms that did not indicate any impact of land privatisation on their investment plans nevertheless indicated that they would welcome land privatisation, as it would enhance the general business/investment climate, creating an indirect benefit for them.

If Land Were Easily Privatised in Ukraine, Would It Affect Your Investment Decision?



Survey Respondents Who Would Follow Easy Land Privatisation in Ukraine by More Investment

percentage of respondents within groups

Investor types/ Sectors	Land in- tensive	Other	Average
MNEs	45	36	41
Entrepreneurial/ other	80	75	78
Invested/committed	62	60	61
Prospective	33	20	25

Out of the abovementioned above 16 respondents, firms in land-intensive sectors were more likely to follow the improvement of land privatisation by more investment and/or expansion of their business activity in Ukraine. However, most MNEs in this group indicated indifference to this issue and to its impact on their future investments. The reason for that is likely to be in the dominance of the market-seeking motive over all the rest of their investment motives. As before, smaller (entrepreneurial) firms appeared more sensitive to the land privatisation process across sectors.

Potential FDI Inflow

Out of those respondents who indicated the intention to increase their investment in case of easy land privatisation, only 3 respondents dared to specify amounts (US$19 million in total). However, the responses of the rest of firms lead us to believe that potential FDI from smoother land privatisation procedures alone might exceed US$100 million across our sample within a 1–2 year span.

Potential FDI from smoother land privatisation procedures alone might exceed US$100 million across our sample within a 1–2 year span. Yet we treat this estimate as biased downward.

Yet we treat this estimate as biased downward. The fact of full land tradability is anticipated to open Ukraine for more investor groups (especially, for small-scale entrepreneurial), as well as open more sectors of the Ukrainian economy for FDI. To illustrate the latter, we take the example of Russian retailing described in McKinsey (1999): in 1991–97, the Russian economy attracted only US$0.1 billion from multinationals investing in modern and more productive chains, versus. US$2.1 billion attracted by Poland (and US$2.7 billion in the pipeline). To date, Ukraine has attracted none of the multinationals to its retailing, though it is comparable to Poland in size. Thus, with clearance of the land privatisation issue, Ukraine's FDI potential in retailing could easily be measured in the hundreds of US$ millions over the medium run.

Another example is the already mentioned hotel business. The lack of good hotels at the medium and high end of Ukraine's market is widely recognized. The cost of building a new 2–4 star hotel with 100 rooms typically runs at US$30 million (according to McKinsey's estimate for Russia), while 5-star hotel projects mostly exceed US$50-million budgets. Thus, the FDI potential for Ukraine's hotels can also be measured in the hundreds of US$ millions over several years.

The **POLICY STUDIES** journal was established by the International Centre for Policy Studies in January 1999. **POLICY STUDIES** presents the results of policy research carried out by ICPS experts, partners, and other think tanks.

POLICY STUDIES is financed by the Open Society Institute.

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Our special thanks for assistance and advice go to the ICPS Director Vira Nanivska and employees of the Centre.

Printed in Ukraine by Pekotoff-print

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